POLICY REPORT

Volume III Number 12 | A PUBLICATION OF THE CATO INSTITUTE | December 1981

Economic Growth: A Market Process Perspective

by Richard H. Fink

The amount of attention currently being given to issues involvng taxation, productivity, and economic growth is largely due to the inability of the American economy to maintain a satisfactory track record in these areas. As a result we have seen many competing explanations of our economy's woes and even more recommendations of how to alleviate these problems. This article will attempt to present a market process theory of productivity and economic growth and then analyze some critical policy areas and their impact on economic growth.

There is no single definitive and all-encompassing definition of economic growth among economists. Economic growth has been associated with a number of different phenomena including technological progress, a "lengthening" of the structure of production, and an increasing stock of capital. However, for the purposes of this article, we will view economic growth as simply a rise in future living standards as compared to present living standards.

Economics has nothing to say about the desirability of economic growth. As long as scarcity exists, men must choose between competing ends, and a choice of one of these ends implies the sacrifice of other ends. Like any other end, economic growth has its opportunity costs, for it must compete with other goals such as less pollution, more present consumption, and more leisure. The advocate of an increase in growth rates is implicitly claiming that the future benefits from such growth outweigh the current sacrifices that are necessary. Which end is most important is a value judgment, and such judgments are outside the realm of the value-free science of economics. What an economist can do is contrast the consequences of, and possibilities for, economic growth in various settings.

"The price system is a critical mechanism for discovering and disseminating scattered, incomplete information."

A useful institutional setting for examining productivity and economic growth is an unhampered market economy, because by initially abstracting from the presence of government policies we can obtain a clearer picture of the consequences of these policies. We can then examine previous government policies which helped determine our present productivity as well as proposed policy measures intended to improve the situation.

A variety of factors are relevant for determining how much an economy will grow and what sort of growth will be achieved. The most important of these factors include such variables as time preference (savings-consumption decisions), the ability of the price system to allocate resources to their most highly valued uses, coordination of plans over time, and the degree to which new investment projects are successfully integrated into the existing capital structure.

To illustrate this point, assume that on one of your frequent trips to the Tax Court your plane crashes into the ocean, and because of your superior swimming skills, you become the sole survivor on a deserted island. After your struggle to reach the shore, you find that you have to search eight hours a day for food just to survive. Let's assume that you prefer fish (as opposed to coconuts or other culinary delights that the island has to offer), so you fish eight hours a day and engage in leisure (rest) the remainder of the day. You soon become unhappy with your present standard of living and want to increase it in the future. Therefore, you decide to fish twelve hours a day, and after two days you have accumulated enough fish to sustain you for a third day without fishing. Now you are facing at least two choices: one of consumption, *e.g.* sunbathing the third day, or investing — building a net to increase your future production possibilities. If you decide to build the net instead of using your extra day for consumption (sunbathing, for example), you have been able to realize economic growth, *i.e.*, raised your future living standard. Now you can catch your daily subsistence of fish in four hours instead of eight hours. The net is a capital good, one not used for final consumption but for production. Your act of savings allowed you to engage in economic growth. The foregoing of present consumption allowed you to develop a more capital-intensive structure of pro-

(Cont. on p. 3)

Richard H. Fink is managing editor of *PR* and director of the Center for the Study of Market Processes at George Mason University. This article is adapted from a chapter in his forthcoming anthology, *Supply-side Economics: A Critical Appraisal* (Frederick, Md.: Aletheia Books, 1982).

EDITORIAL

State and Local Governments: Service or Disservice?

Given the present trend, and there is little reason to expect a favorable change, the growing crisis of state and local governments will continue to seriously harm an economy already significantly impaired by forty years of irresponsible federal policies. State and local governments across the country are experiencing difficulty paying for such elementary services as roads, sewage, water, mass transit, and fire and police protection. However, the worst is yet to come.

If Reagan follows through on his promises, then state and local governments can expect significant cuts in federal subsidies. In addition to this revenue loss growing unrest on the part of taxpayers will seriously jeopardize efforts to recoup these revenues by increasing local taxes. Not only do municipalities face the prospect of higher borrowing costs (because of the higher than expected interest rates), but they are losing some of their subsidized advantage in the credit markets; Reagan's tax cuts have made tax-free municipal bonds less attractive as a result of the reduction in marginal tax rates. The All Savers certificates will also compete with the attractiveness of municipal bonds.

In addition to declining revenues, state and local governments also face the prospect of dramatically increased expenditures to keep the level of services from deteriorating. For instance, estimates of state and local obligations for streets and highways are around $700 billion for the decade of the eighties—this is more than all public works investments combined during the 1970's. Furthermore, this $700-billion figure covers only rehabilitation and reconstruction, not new construction. The problem is not specific to highways: two of every five bridges in the nation are in need of replacement or significant rehabilitation because of neglect, at a projected cost of $41.1 billion. The nation's sewage system will require $31 billion to keep functioning. Our water supply will require an estimated $110 million for repairs.

Of course, state and local governments should have foreseen that durable equipment needs periodic maintenance and replacement. For years state and local governments have misused funds for political patronage and public-works boondoggles. New buildings have been constructed for the high visibility of ground-breaking and ribbon-cutting ceremonies, despite the lower-cost option of maintaining and rehabilitating existing buildings.

The steady decline of state and local government as a tolerable supplier of needed services has significant secondary consequences for businesses and consumers, as well as taxpayers. Not only are many businesses jeopardized, but everyone suffers from the decline in productivity caused by poorly supplied government services. For example, U. S. Steel Corporation is losing $1.2 million per year in employee time and wasted fuel re-routing trucks around the Thompson Run Bridge in Duquesne, Pa., which is posted for weight restrictions because it is in such disrepair. Companies wanting to locate in certain downtown areas of Boston must bear the additional cost of a sewage holding tank to avoid overloading the system during peak hours. Companies in Manhattan lose an estimated $166 million a year for each additional five-minute delay on the subways and buses.

Perhaps an even more significant drain on the economy is the intrusion of state and local governments into capital markets, where they unfairly compete with private borrowers for the supply of available credit. Credit that would have gone to finance needed private ventures is diverted into government projects, limited only by the near unrestricted access to taxpayers' pocketbooks.

Now is the time to halt further deterioration by privatizing state and municipal services. We should not try to avoid facing the problem; that will only cause further disruptions to the economy. We should reject proposals — such as those in a recent *Business Week* editorial — that have included increased local taxing power; a centralized capital bank to handle all government projects; "cooperative" business-government ventures; and a reconstruction bank based on the lines of Herbert Hoover's misguided Reconstruction Finance Corporation (see Sheldon Richman, "Let Sleeping Failures Lie: The Reconstruction Finance Corp."; *Policy Report*, Nov. 1980).

Economic theory has again and again alerted us to the misallocation and coordination problems generated by these schemes. History is filled with concrete examples of their disastrous results. The only sensible path to take is to separate state and local governments, with all their abuses and mistakes, from the provision of these essential services. ■

Economic Growth (Cont. from p. 1)

duction (traditionally called lengthening the structure of production).

In this primitive society savings directly determined the level of investment, for the number of fish you caught directly determined how many days you could devote to investment (building the net). This direct relationship between savings and investment is altered in a complex monetary economy, as the existence of money creates an "intercession" between savings and investment. Acts of saving and investment will usually be performed by different groups of individuals (or individuals acting in different roles) who will most likely have different purposes. As a result the relationship between interest rates, profits, and relative prices become the coordinating market forces between savings and investment.

In a complex industrial society such as the United States the price system is a critical mechanism for discovering and disseminating information: information that is scattered in incomplete, half-accurate form in the minds of the millions of economic actors, information about the thousands of economic resources and almost limitless possible combinations of these resources. Economic actors, by bidding for goods and services, are in competition for the use of scarce resources. The more urgent the demand, the more people are willing to pay for the resource. This bidding for resources allows prices to allocate resources according to their most valued uses. Profits provide the incentive for utilizing the information disseminated by prices in an effective manner.

Additionally, besides rewarding successful behavior and penalizing entrepreneurial errors, profits act to redirect the command of scarce resources away from entrepreneurs who either are inept at reading price signals or have bad information (and thus suffer losses) toward entrepreneurs with a demonstrated record of success (i.e. profit makers). Profits tend to put money resources and therefore the command of scarce resources in the hands of entrepreneurs who have demonstrated good judgment. Thus, profits and losses play at least two key roles in a market economy: they provide incentives to produce the goods that consumers most urgently want and direct resources into the hands of those most competent in bringing the goods to market.[1]

The Role of Interest Rates

The interest rate is an important market signal in redirecting resources across time, as it captures individuals' preference for economic growth as well as their commitment to sacrifice the present consumption to realize this growth. Interest rates are, therefore, a critical information-generating signal for savings and investment and hence the prospects for realized economic growth.

To the extent that the rate of interest tends toward its equilibrium level, it will serve to coordinate before the fact the plans of savers and investors by disseminating information about the terms on which economic opportunities will be offered.

The very act of increasing saving relative to present consumption on the part of an individual implies that his demand for present consumer goods has gone down and that his demand for future consumer goods has increased. After all, few people save indefinitely for no reason — most people save to provide future consumption in a few years, for their old age, or for their heirs. How much an individual saves depends on his time preference in conjunction with the constraints he faces in the market, with prices being one important component of these constraints.

Time preference is the subjective evaluation of future income in relation to present income. The decision to save $100 today in order to be able to purchase $110 worth of goods next year indicates a time preference rate of 10%. You prefer $110 a year from today over spending the $100 today. A person who prefers the $100 today would have a higher time preference than you — he would require something higher than

(Cont. on p. 4)

In This Issue

POLICY REPORT
ISSN: 0190-325X

Published by the Cato Institute, *Policy Report* is a monthly review that provides in-depth evaluations of public policies and discusses appropriate solutions to current economic problems.

David Boaz . . . . Executive Editor
Richard H. Fink . . . . . . Managing Editor
Tyler Cowen, Daniel Klein . . . . Research

Subscriptions and correspondence should be addressed to: *Policy Report*, P.O. Box 693, Englewood, CO 80151. The annual subscription rate is $15.00 (12 issues). Single issues are $2.00 per copy. *Policy Report* is published monthly by the Cato Institute, 224 Second Street, S.E., Washington, D.C. 20003. Second-class postage paid at Washington, D.C. POSTMASTER: Send address corrections to P.O. Box 693, Englewood, CO 80151.

Economic Growth (Cont. from p. 3)

$110, perhaps $120, to induce him to save the $100 today for the opportunity to spend it a year from now. As can be seen from this example, time preference is merely the tradeoff we all have between present goods and future goods. We save today in the expectation of being able to exercise an increased ability to demand goods in the future (future goods). This is what the demand for economic growth is: the preference for a rise in future living standards at the expense of present living standards (consumption). To realize this, increased preference for growth requires increased saving — the present sacrifice for future gain.

How does the market respond to this decline in present demand for consumption goods and the increase in future demand that results from the decision to increase savings? It responds in the same way as it does whenever the relative demand between any other two goods changes — it provides the incentive and the information for entrepreneurs to decrease the supply of present goods to match the decreased demand and to increase the supply of future goods to match the increased future demand. When people decrease their present demand for goods, the funds generated by this saving increase the amount of money in the loan market and this decreases the interest rate. The lowered interest rate allows entrepreneurs to borrow these funds for new investment projects that will eventually bring an increased supply of goods to the market, just as the net in our desert island example increased the future supply of fish.

The previous discussion should help clarify the importance of prices and intertemporal coordination for any discussion of economic growth. Intertemporal coordination is necessary for savings to be converted into the most highly valued investments, and the price mechanism is the primary means through which this process is accomplished.

Perhaps the least understood feature of economic growth is the necessity of creating new capital goods which will perform a complementary function with other capital goods. The importance of this particular sort of coordination is often forgotten by neoclassical models which treat capital as a homogeneous aggregate rather than as a heterogeneous structure. However, different sorts of new investments may not be treated as equivalent since such investment will effectively "interlock" with the existing capital structure to a different degree. A good example of the importance of this point is given by Western aid to underdeveloped nations. While agencies such as the World Bank may advance the capital which allows less-developed countries to purchase such technologically advanced ventures as steel mills, hydroelectric plants, and mechanized agriculture, these projects are rarely integrated into the structure of production of the underdeveloped nation. More often than not, the LDC will have little or no support industry to produce spare parts, to train the necessary highly skilled labor, or even to use the produce of the new industry.

The extent to which an economy manages to coordinate its capital structure is due primarily to the degree to which its key market signals — prices, profits and interest rates — are not impeded by government intervention in performing their coordinating functions. These interventions may take such forms as regulations, price controls, quotas, misallocations of property rights, and inflation.[2]

The Effect of Government

Problems of growth and macroeconomic policy should begin with a microeconomic market process framework. The macroeconomic questions to be investigated concern possible distortions of saving, the interest rate, the incentive to invest (profits), the relative profitability of investing in certain areas versus other areas, and the coordination of plans of production by individual entrepreneurs and the plans of consumption by individual consumers (prices). None of these questions is adequately addressed in aggregate demand models or aggregate supply models.

Using a market process framework, some interesting questions arise concerning the low rate of economic growth of the United States during the past twenty years. What factors will affect individuals' proclivity to save — to finance economic growth? One important factor is that people have to pay income taxes on the money they earn from working. Whatever is left over after they pay an income tax is used to purchase present consumption goods on which they more often than not pay a sales tax. If they own property, they pay additional property taxes. If they leave money to their family when they die, they pay inheritance taxes. If they want to provide for other people while they're living, they pay gift taxes. Whatever is left to save and generate interest income is also taxed. When all taxes, visible and hidden, are taken into account, nearly half of a person's income can go to taxes. After that, a major part of his remaining income will usually be spent to provide subsistence in the present, namely housing, food, clothing, etc., leaving very little for savings.

However, besides the burden imposed by taxes, the American consumer is able to extract far fewer products out of his remaining income because there are fewer goods available and the prices they command are greater as a result of thousands of government regulations and edicts. Controls affecting prices, such as minimum wage laws, interest rate regulations, milk price supports, natural gas price regulations, rent controls and subsidies, all result in a greater drain on the consumer's pocketbook.

The problem discussed here is twofold. The first difficulty is that these economic policies will substantially diminish the stock of goods available for future consumption. However, an even more significant problem is not so much the effect on total output but rather how these policies influence the structure of production, and therefore, what goods and services are produced in the future. Prices that normally direct resources into those channels of industry that satisfy the most urgent demands of consumers are artificially altered. Marginal producers will exit the industry and non-specific factors will be shifted into other industries. Specific factors may lie idle instead of being utilized to produce the goods that consumers most readily demand. Resources will shift out of over-regulated and price-controlled sectors into less urgent uses, such as subsidized industries. Effort and expenditure normally devoted to production will be diverted into avoiding the wealth losses from unfavorable regulations and clamoring for subsidies and favorable regulation. All of these distortions have serious consequences both for the quantity of savings and for the uses to which these savings are put. A more thorough examination than is warranted here would examine further distortions to productivity by examining labor unions, tariffs, licensing laws, and other interventions which lead to distorted prices for goods and services.

Now to this strain on savers we add inflation, which has destroyed traditional avenues of saving as well as pushed people into higher tax brackets even though their real income may have decreased. Regulations on the maximum interest rates that financial institutions can offer have also discouraged saving. A dollar invested in tax avoidance and/or tax evasion may bring a much larger return than a dollar devoted to saving. Lastly, what saving *is* encouraged is usually channeled into consumer durables, such as housing, because of tax laws, inflation, and subsidies. Any treatment of economic growth should investigate these effects.

Government policy also affects economic growth through its impact on investment decisions made by the producers of the actual capital equipment, the steel mills, and the research and development necessary to supply the goods that will help generate a rising standard of living. A brief review of several pertinent facts is revealing. The corporate sector of the United States has been taxed at a nominal rate between 40 and 50%. However, after taking inflation into account, the real tax burden is sometimes over 100%. The impact of such a high rate of taxation on the profitability of investment is staggering. According to Martin Feldstein of Harvard University and the National Bureau of Economic Research, the average rate of return on investment is around 4%. A 4% return on capital invested is generally not an adequate incentive for the risks and efforts of many entrepreneurs.

Regulation and Inflation

Other reasons for the low return on capital invested include the hidden tax

(Cont. on p. 6)

Briefs

☐ So that Bedford, Indiana, may build a monument to the $15 million limestone industry of Southern Indiana, the federal government is spending $700,000 to build a 96-foot-high limestone version of the Egyptian pyramid of Cheops and an 850-foot-long limestone replica of the Great Wall of China. The federal government defended the project on the grounds that "it gave the promise of bringing some economic development to a very poor part of Indiana, which was our mission."

☐ A recent study by the General Accounting Office has estimated that the automobile gasoline mileage estimates derived by the Environmental Protection Agency are off by an average of 16 percent. Another source, *Automotive News*, claims that real city-driving mileage is about 14 percent less than EPA estimates, while highway fuel-efficiency is overstated by about 25 pe cent. These discrepancies are attributed to the failure of the EPA to sufficiently take into account terrain, tires, traffic, driver temperament, and the condition of the automobile.

☐ An audit of the Economic Development Administration (EDA) found that the EDA has a portfolio of $509 million in direct loans and $446 million in guarantees to banks. Approximately 40 percent of this figure "is delinquent or has stopped," and if business conditions worsen, this figure is expected to rise over 50 percent. Thomas Dunne, a consultant for the Commerce Department, stated that until the EDA was privately audited, no one even knew how many loans they had made. Dunne added, "The general philosophy of this agency has been to get the money out; it's good politics."

☐ The federal government has announced that next year the Social Security tax will be levied on the first $32,400 of an individual's earnings, up from $29,700 this year. When this effect is combined with the increase in Social Security rates scheduled for Janaury 1, the maximum Social Security tax will rise nearly 10 percent, to $2,170.80 per employee. The average worker will experience an increase of approximately $100. The increase in earnings subject to Social Security taxes is $300 more than the Reagan administration had predicted.

☐ Per capita spending by state governments exceeded $1,000 for the first time in 1980, according to the Census Bureau. Nationwide, state governments spent an average of $1,010 per resident, up from $913.79 the year before. Lowest on the list is Florida, with $719.21 per capita, while at the other end of the scale is Alaska, with $4,826 per capita.

Economic Growth (Cont. from p. 5)

of regulation that has been estimated to cost businesses from $20 to $200 billion a year. Another factor is the tremendous consumption of our national resources by government, a process which drives up the prices of the remaining resources. Government absorption of resources that would ordinarily go to produce goods and services is nowhere so evident as in the labor market where it has been estimated that the employment of one of every five workers is government-related. Government bail-outs and subsidies to inefficient firms not only waste valuable resources but also impinge on the normal incentive structure of the unhampered market. Major industries such as automobiles, television, and steel are now clamoring for protection from foreign competition in order to lessen the market forces of competition that weed out inefficient producers. Corporate America, like the individual citizen, finds that it is extremely profitable to devote scarce resources not to produce but to discover ways to reduce their tax and regulatory burden. Firms find that a dollar spent lobbying in Washington for special favors brings a greater return than a dollar spent in production. Rather than outcompete a rival, it is cheaper to lobby for selective regulations to drive him out of business.

Unemployment insurance, minimum wages, immigration laws, affirmative action quotas, welfare, CETA, and government intrusions into the labor market raise the cost of production tremendously. Union activity, normally part of the market mechanism, has been distorted by government interference which allows unions to prevent lower-income people from bidding jobs away from higher-paid workers in industries with union-induced wage scales. Strikes and the threat of strikes can cause a tremendous amount of resources, normally devoted to enhanced production, to be devoted to increased inventories in order to allow a firm to survive a strike.

Inflation is another factor that has received a tremendous amount of attention but has not been fully integrated into the microeconomics of economic growth. Most analyses of inflation ignore the fact that relative prices are distorted as new money is pumped into the economy because the money enters in specific ways and therefore raises specific prices in a certain order.[3] As these artificially induced prices continue to rise, entrepreneurs respond as they do to all relative price changes — they redirect resources into the newly profitable areas. This malinvestment is reversed when the government stops pumping new money into the economy (or more often, slows the rate of increase), so there is good reason to suspect that the boom induced by government policies affecting the money supply is causally related to recessions (where the malinvestments are revealed). The economist studying economic growth must address these business cycles where a large amount of resources are wasted because for some reason *most* entrepreneurs in particular sectors of the economy are in error, when in normal times only some entrepreneurs make errors while others are highly successful. Why do these highly skilled professionals systematically err at one particular point in time and cause a recession? The creation of false price signals generated by government-induced monetary expansion provides some interesting clues.

"An economy can only coordinate its capital structure if its key market signals are not impeded by government intervention."

While many analysts recognize the income redistribution effects of inflation, most are either unaware of or deny the serious redistribution of resources caused by inflation. One example of this redistribution of resources can be seen operating through the "time market." Earlier in this paper, the critical link between economic growth, the quantity of savings, and the interest rate was explained. We saw that when individuals lower their time preference (decreasing their present consumption and increasing their savings), they are effectively exercising an increased demand for economic growth. Suppliers react to these future demands when the increased saving lowers the interest rate and therefore makes investment less costly than before. Not only are most investment projects stimulated, they are stimulated to different degrees. The relative profitability of longer-run projects increases relative to shorter projects. A short example will illustrate the point:

Assume that you are faced with two investment projects that have the same net present value after you take into consideration outlays, expected income, and subjective preferences. Investment project one returns $1,100 in income in one year and no revenue thereafter. Assuming the interest rate to be 10%, the net present value of this project is $1,000. Investment project two returns $100 in revenue every year in perpetuity. If the interest rate is 10%, net present value of this investment project is $1,000. Assuming that you have incorporated all your subjective preferences into the outlay and revenue figures, you should be indifferent between these two projects.

Let's suppose that the interest rate declines because of the increase in the supply of savings to 5%. The net present values of these two projects will increase but to different degrees. While the net present value of investment project one will increase 5%, the net present value of investment project two will increase 100%, making the longer-run project a much more attractive investment.

This example illustrates the crucial coordinating role played by interest rates. Just as distorted prices cause a misallocation of resources in various markets, distorted interest rates cause a misallocation of resources over time.

Past monetary policies have affected interest rates in a systematic fashion and therefore generated systematic effects in the capital goods markets. As government pumps money into the economy through the commercial banking system, the banks find that they have more money to lend out. In order to lend out this increased quantity of money, they lower the interest rate — generating an increased quantity demanded of funds, and as shown above, altering the relative attractiveness of various investment projects by making longer-run projects relatively more profitable. To the extent that entrepreneurs base their plans on the lower interest rate, they are responding as if consumers demanded more economic growth when in fact they do not. In this way monetary policy generates false signals, inducing entrepreneurs to supply an increased quantity of future goods to consumers who have not expressed this preference.[4]

Policy Recommendations

If one were to accept the goal that government policy should be primarily concerned with increasing productivity and stimulating economic growth, then the market process perspective presented above would dictate that the government go about systematically eliminating policies that distort market signals, particularly relative prices, profits, and interest rates. One would first attempt to eliminate those policies that

(Cont. on p. 8)

✓ Washington Update

The State Department is considering ending U. S. support for the United Nations Environment Program (UNEP), a project which is basically used as a forum to encourage discussion between the West and the Third World. Last year's American contribution to UNEP was $10 million, one-third of the agency's budget. It is expected that a cut-off of U. S. aid would probably kill the entire operation.

Environmental Protection Agency head Anne M. Gorsuch has reportedly drawn up a 1983 operating budget for the EPA which would cut the budget by 20 percent from her 1982 request of $1.19 billion. Such a cut would eliminate 3,200 EPA jobs, cutting the staff by almost a third. Among the projects expected to suffer the most are the Superfund for toxic waste cleanup, regulations for tracking industrial waste and constructing safe disposal sites for it, and testing of new chemicals.

President Reagan's authority to impose price controls on oil or to allocate supplies of oil and gasoline expired recently. President Carter had begun phasing out these controls in 1979, a task that was completed by Reagan. Although Congress is moving to restore such authority to the President, administration officials have testified against the legislation on the grounds that the President already has sufficient authority to act in the instance of an emergency.

Budget Director David Stockman has announced that all federal departments and agencies must seek approval by next January 15 for each periodical they wish to continue publishing. Those publications not reapproved will cease to exist by next March 15. Stockman's recent announcement is considered a complement to his earlier plan to place a moratorium on new publications.

The Treasury Department has drawn up a rough draft of its new tax increase plan — a plan designed to recoup $22 billion of the $288 billion the Treasury will lose through 1984 from Reagan's tax cuts. Items in the Treasury plan include accounting rule changes which reduce a corporation's ability to defer certain taxes on earnings till next year, elimination of several tax exemptions for insurance companies, and a decrease in tax breaks for "industrial development" bonds. Rather than label this package a "tax increase," the Treasury is calling it a "revenue enhancement" proposal.

The Reagan administration has indicated that it intends to significantly change the water policy which had been adopted during the Carter administration to give Interior Secretary James Watt more power to decide what projects to build. Environmental quality will be dropped as a major water policy objective, and machinery for the independent review of water projects will be scrapped. The administration also tends to discard an intricate series of principles and standards for water projects that was formulated by the Corps of Engineers.

Housing and Urban Development Secretary Samuel R. Pierce says that a voucher system giving direct cash payments to the poor for housing is "pretty much a certainty." Pierce pointed out that such a system of vouchers would replace the so-called Section 8 program, which provides assistance for low-income renters by giving funds directly to either landlords or local housing authorities. A committee of the President's Commission on Housing has also supported Pierce's idea that Section 8 be replaced by vouchers.

The Reagan administration is seeking to restore the solvency of the black lung disability fund, an action which would entail doubling the severance tax on coal. A draft of proposed legislation is said to "steer a middle course" by raising taxes and tightening eligibility rules. The fund's deficit has now reached $1.2 billion and is rising steadily.

Economic Growth (Cont. from p. 7)

cause the most distortion. This is hardly an easy task, but certainly monetary policy would have to be considered as important as realigning incentives through tax policy. Tax policies designed to alter incentives to increase the level of savings and investment are of questionable value if this encouragement results in the production of things that nobody wants. Supply-side tax policy must be accompanied by an equal focus on coordination problems caused by other distorting economic policies.

It would be best, of course, to repeal first those policies that have the most distortive effects on the economy. However, if political reality dictates beginning with a program of across-the-board tax cuts, critics of supply-side policies would be wrong to criticize such a move. But insofar as these critics are alerting supply-siders to unaddressed or under-emphasized problems associated with huge deficits and the level of government spending, their advice is invaluable. Supply-siders must understand that the lack of incentives is only part of the productivity problem and that there must be a systematic effort to repeal distorting economic policies. The level of savings and investment is important, but problems of market coordination may be even more significant.

The key right now is to keep moving in a positive direction — toward reducing disincentives and market distortions — and not to bog down in an endless debate over which step to take first.

The points of agreement between the supply-side and market-process perspectives should be obvious. While market-process economists might prefer a different method of cutting taxes, any moves in that direction after the past forty years are a welcome change. But market-process economists would take issue with the exclusive focus on tax policies and incentives, understanding that the problem of monetary policy, deficits, and the level of government spending are at least equally important. Government interventions on the supply side — "reindustrialization," new taxes on consumption instead of investment, business subsidies, and the like — would damage long-run prospects for economic growth in the same way that past demand management policies did. Like the earlier policies, they would distort market signals and misallocate resources. Economic growth requires not a different kind of intervention but the elimination of government intervention in the market process. ■

[1]See Murray Rothbard, *Man, Economy and State* (Los Angeles: Nash Publishing, 1961), chapter 6.

[2]See F. A. Hayek, "The Use of Knowledge in Society," *American Economic Review*, September 1945. Reprinted in F. A. Hayek, *Individualism and Economic Order* (Chicago: University of Chicago Press, 1948).

[3]See F. A. Hayek, *Monetary Theory and the Trade Cycle* (New York: Augustus Kelley, 1966).

[4]See F. A. Hayek, *Prices and Production* (New York: Augustus Kelley, 1967).

The All Savers Certificate Program

by Roy E. Cordato

With all of the noise and media hype surrounding the All Savers certificates, certain important questions are consistently overlooked. While even a partial deregulation should merit at least some applause, no reference is made to those questions concerning the allocative effects of this program and the amount of sense the program makes for the recovery of the economy as a whole. In other words, what's good for the savings and loans might not be in the best interests of market participants and the efficient allocation of resources. Even though the All Savers certificates were instituted as part of President Reagan's general tax cut package, which in turn is meant to stimulate savings and economic growth, the impact of this tax-free savings program might very well be inconsistent with these stated objectives. That is, its effect may be to shift existing savings rather than encourage new deposits and push the economy even further in the direction of minimal growth and resource misallocation.

Roy E. Cordato is a graduate student in economics at Auburn University.

The All Savers certificates, which became available on October 1, 1981, allow savings and loans and other banking institutions to offer tax-free interest, pegged by Congress at 70% of the yield on Treasury securities, to anyone willing to invest at least $500 for a minimum of one year. In particular, the program allows savers to exclude up to $1000 ($2000 on a joint return) of their earnings on the certificates from their taxable income. As an extra boost in attracting funds to the certificates, the Federal Home Loan Bank Board, the agency that is responsible for the regulation of savings banks, has ruled that funds already invested in high-interest-bearing six-month money market certificates can be rolled over into All Savers certificates prior to maturity without suffering the usual penalty for early withdrawal. Because of this provision *Business Week* magazine speculates that "as much as half of the $206 billion held in six-month certificates could flow into the All Savers certificates by the end of 1982."[1]

The obvious short-run objective of all this is to allow the ailing savings and loan industry to be more competitive with the various high-interest-yielding money market funds without having to pay the higher competitive rates asso-

ciated with either those funds or the six-month money market certificates. In return for this the participating institutions must agree to make available 75% of the net increase in revenues associated with the All Savers certificates for housing and agricultural loans — the point here being to channel resources into the slumping housing and farm sectors of the economy.

How do these provisions coincide with the overall objectives of the Reagan tax cut program? Will the All Savers program contribute to overall economic growth or simply aid one sector of the economy at the expense of other, more productive sectors?

The All Savers Certificates and Resource Allocation

One of the prime objectives of the Reagan tax cut, and the supply-side approach in general, is to stimulate additional savings in the economy by providing incentives that bring about greater rewards for savers. The logic behind this is that a net increase in savings will lower real interest rates which will in turn encourage new investment and stimulate economic growth. The problem is that in spite of the incentives tax-free investment should provide, the All Savers certificates are not expected to generate great amounts of new savings. As the *Wall Street Journal* has pointed out, "It's not so much an incentive to save as it is to save in a certain way."[2]

This is primarily because of two provisions in the All Savers program. The first and most important is the interest rate ceiling which is set at 30% below the going rate on Treasury bills. This, combined with its tax-exempt status, allows the certificates to be an attractive investment only to those in the 30% or greater tax brackets. Therefore, the bill is not likely to have any effect on the savings habits of those in lower tax brackets. Consequently, most observers have concluded that the All Savers certificates will be primarily viewed as a relatively better investment for funds already earmarked for savings rather than an incentive that will bring about a net increase in saving. As the *Wall Street Journal* concludes:

> It will just draw savings away from the equity market, the municipal bond market, and the money market funds and pour them into the housing market.[3]

The second provision, and most blatant in its attempt to encourage saving "in a certain way," is that provision which allows the penalty-free shifts from the six-month money market certificates into the All Savers certificates prior to the six-month certificates' maturity date. This particular provision can have no other purpose than to encourage the movement of resources from one type of investment to another in an attempt to lower the cost of existing funds to the savings and loans.

"There is nothing in the All Savers program that would encourage the savings and loans to use their resources more efficiently."

If the All Savers certificates are not expected to attract significant amounts of new savings, we should analyze the resource reallocation that the program can be expected to bring about. The theoretical implications of such a reallocation are clear—the All Savers program as instituted can only result in the misallocation of resources and the inefficient use of capital.

This situation should be contrasted to an unhampered market where those financial intermediaries that choose the most efficient and therefore most profitable investments will also be able to offer the most lucrative interest rates to potential savers. Because of this, in an economy free of interest rate and investment restrictions, savings will automatically go to those institutions that are most likely to make efficient investments and therefore promote economic growth. The new All Savers certificates represent a movement away from, rather than in the direction of, this free market ideal. The combination of tax-free income and controlled interest rates that characterizes the program allows the institutions involved to offer more attractive returns without being more efficient. In essence, the thrift institutions are now able to attract savings from previously more lucrative investments such as money market funds, not because they are suddenly using their resources more profitably, but because the government has distorted the relative incentives faced by savers.

In particular, the government has decided to continue penalizing, through taxation, those savers who invest in any of the otherwise more profitable money market instruments while eliminating the tax penalty on the All Savers certificates. To the extent that these other market instruments are operating in an efficient environment, resources are diverted from relatively more productive to less productive uses.

This result is further encouraged by the requirement that 75% of the new revenues generated by the All Savers certificates go into housing and farm loans, regardless of the relative profitability of those types of investments. Again, if we look at an unregulated market we can see how the efficient use of capital is insured. When the general mood of the country is oriented toward saving and planning for the future, as has usually been the case during periods when little or no inflation is expected, interest rates will be relatively low, long-term loans will be made, and capital investments will be carried out. The nature of these capital investments will depend on the perceptions held by the different entrepreneurs in the consumer markets, since only capital formation that is ultimately meant to satisfy future consumer demands can be profitable.

(Cont. on p. 10)

All Savers (Cont. from p. 9)

Therefore, those entrepreneurs who perceive consumer demands most accurately when making investments will be both the most profitable personally and the most productive in terms of economic growth, that is, in terms of satisfying consumer wants.

In retrospect we can now notice a chain that develops in a free, unhampered market that insures efficiency and economic progress. As we have just seen, entrepreneurs who are the most successful in perceiving consumer wants will be the most profitable in their investment endeavors. Given that banks and other financial intermediaries are also anxious to make investments in profitable ventures, the free market will automatically channel loanable funds to those entrepreneurs who have the best track record in turning a profit, and therefore perceiving consumer demands. As we have also noted, those banks that make the most profitable loans would also be in the position to pay the highest interest to savers, therefore seeing to it that savings are also channelled into their most productive use.

With the All Savers certificate we can now see that the market is distorted at both ends of this chain. Not only are savers given an incentive to save with otherwise less profitable institutions, but the institutions themselves are required by law to invest 75% of these funds into areas, namely agriculture and housing, that they may perceive as less than optimally profitable and productive. The final result here has to be not only a reallocation of resources in the direction of housing and agriculture, but a misallocation of resources away from those areas of greatest productivity and consumer satisfaction. To the extent that productivity is lessened because of these misallocations (something that can never be accurately measured), the entire All Savers program will be inconsistent with the overall purpose of the Reagan plan.

The Competitiveness of Savings and Loan Associations

Even if the All Savers certificates are not consistent with increasing productivity and economic efficiency, both the supporters and opponents of the program generally conclude that it will at least increase the competitive standing of the savings and loan industry. But even this assumption is questionable.

Until the end of 1982, the savings and loans will be in a position of attracting some capital away from money market funds and other financial instruments—capital that, in recent years, has been lured away from the savings and loans by these more attractive investment opportunities. But does this represent true competition? Could the All Savers certificate possibly make the savings and loans more competitive in any economically meaningful sense of the word?

To answer these questions, we must first examine exactly what it means to be competitive. To the economist the concepts of competitiveness and efficiency are inseparable. In order for any firm to become more competitive it must first find methods of using its resources more efficiently. Those firms that most efficiently utilize their resources will also be the firms that can offer the lowest prices and the highest quality product. Thus the key to competitiveness is efficiency.

From our previous discussion, it is clear that there is nothing in the All Savers program that would encourage the savings and loans to use their resources more efficiently. In fact, the op-

GOVERNMENT SPENDING MONITOR

A quarterly feature of *Policy Report*, the "Government Spending Monitor" summarizes the latest expenditures by the federal government.

EXPENDITURES (annual rate in billions of $)

	1981 3rd Quarter	1981 2nd Quarter	1981 1st Quarter	Average for Last Year
Federal Government	661.1	669.7	668.8	660.5
Defense	165.0	159.9	176.0	162.5
Labor	26.5	28.2	34.4	30.1
Education	13.7	14.9	17.2	15.0
Health and Human Services	245.5	229.2	226.0	230.3
HUD	11.3	16.8	13.6	14.0
Energy	12.8	14.5	9.6	11.6
Transportation	23.4	18.3	26.4	22.5
Aid to State and Local Governments	87.0	88.7	90.2	88.7
Federal Interest Paid	92.7	107.0	81.3	91.2
Federal Transfer Payments	292.1	275.2	271.9	276.8
Federal Surplus or Deficit	–34.3	16.2	–128.4	–70.1
Reported Federal Debt	1,003.9	974.8	964.6	965.2
Total Government Employment, All Levels (millions)	15.3	16.0	16.2	15.9

Source: *Monthly Treasury Statement of Receipts and Outlays of the United States Government.*

posite is true. The government has forced inefficient resource use upon the savings and loans, along with the other participating banking institutions, while at the same time imposing a rate structure that gives the appearance of competitive behavior.

If capital markets were deregulated there would be no inconsistency between competitiveness and productivity. Those firms which are the most attractive to consumers, i.e., the most competitive, are necessarily the most efficient and productive. Our conclusion must be that the All Savers certificate cannot make the savings and loans more competitive in the accurate sense of the word.

This is not meant as an attack on the savings and loan associations themselves. Since 1966 the savings and loans have been prohibited from offering competitive rates of return on time deposits, and these restrictions are scheduled to remain in effect until 1986. Along with this, they have always faced severe legal limitations on the types of investments they have been allowed to make, with the bulk of their assets tied up in home mortgage loans. These restrictions, along with the fact that the return on their outstanding debt is constantly being eroded by the Federal Reserve Board's inflationary monetary policies, have put the savings and loans at a distinct competitive disadvantage (mortgage loans were being made in the sixties and early seventies at annual rates of as low as 5%-7%, and they are now being repaid in decidedly cheaper dollars). Now with the All Savers program, the savings and loans are, once again, not allowed to compete. The rates they can offer are held below market rates and the investments they can make are regulated investments.

In late August and early September of 1981, many savings and loans made an attempt to circumvent the rate restrictions imposed by the All Savers certificates by offering extremely high interest bonuses, with rates as high as 50%, to those who would commit themselves to the certificates prior to October 1. This was done in an attempt to raise the effective yield, both as a way of making it more attractive to those in lower income groups and as a way to compete with other savings and loans for the new-found All Saver certificate dollars. The savings and loans were able to do this because of a financial instrument known as repurchase agreements (repos) which are short-term government loans available to financial institutions. The investors who were taking advantage of these high interest offers were actually buying into a portion of the repos. Even though the savings and loans were paying 18% interest to the government on the repos, they were willing to absorb the loss in order to make the All Savers certificate more attractive. This action by the savings and loans should have been expected, as it was simply an attempt to allow natural market forces to assert themselves. Unfortunately, the IRS quickly stepped in to prohibit even this minor attempt by some savings and loans to become competitive financial institutions. The IRS ruled that any agreements tying the high interest rates to the All Savers certificates were illegal.

"Decontrol would allow the more efficient coordination between the consumer and capital markets that is necessary to bring about economic growth."

The point to be made here is that there is no real competition allowed either between the savings and loan associations and other financial institutions or among the savings and loans themselves. To say that the savings and loans are now more competitive because of the All Saver certificates misrepresents both the true nature of competition and the competitive status of the savings and loan industry.

Toward a Policy of Competition and Growth

In looking back over the previous analysis, it is clear that a policy does exist that will promote both competition among financial institutions and economic productivity—a policy of allowing free market forces to exert themselves.

What is needed is immediate decontrol of all capital markets. This would include the elimination of all controls on interest rates and all regulations that impose restrictions on the types of investments that both financial institutions and entrepreneurs are allowed to make. This would allow all financial institutions to be as efficient, and therefore as competitive, as they can be, given their managerial and entrepreneurial talents. Along with this, the policy of decontrol will allow the more efficient coordination between the consumer and capital markets that is necessary to bring about economic growth.

In addition, if the objective is a higher level of savings and investment in general, then a stable monetary policy, perhaps a return to the gold standard, and the elimination of all corporate and interest-income taxes, along with dividend and capital-gains taxes, would unquestionably push the country in the desired direction. The elimination of inflation would go a long way toward convincing savers that profitable interest rates today won't be eaten away by rising prices tomorrow. Along with this the elimination of the aforementioned taxes would allow all investments to be as profitable as possible, insuring the most efficient and productive level of investment spending. ■

[1] "All Savers raise more than tax questions," *Business Week*, Sept. 14, 1981, p. 30.

[2] "Tax Bill Dross," *Wall Street Journal*, July 22, 1981, p. 28.

[3] *Ibid.*

"To be governed . . ."

Because of the unique value of the following item in illustrating the absurdity of government regulation of the economy, we are departing from the usual format of "To be governed . . ." in order to present the entire story. We'll have a full selection of items in next month's "To be governed . . ."

The regulatory process

When five members of the Federal Communications Commission went behind closed doors last April to decide how high American Telephone & Telegraph Co.'s return on investment should be, their discussion didn't focus on the merits of the opposing arguments they had heard in the two-year inquiry.

Instead, their discussion dwelt on how to minimize the public relations fallout of the record-setting increase to 13% from 10.5% that they clearly already had determined they wanted to grant the company. They ultimately told AT&T to "target" a 12.75% return in setting its rates, but said the allowable return could range as high as 13%. Within weeks, their decision translated into a 16% nationwide increase in long-distance telephone rates, which meant $1.4 billion in annual revenue for AT&T.

The agency released a videotape of the private session yesterday, under pressure from Congress. The tape showed that the five commissioners, including former acting Chairman Robert E. Lee, who has since left the agency, were operating under the assumption from the moment the meeting began that they would grant AT&T the 13% return it sought. But Abbott Washburn was worried, he warned his colleagues, that headlines the next day would read, "billions of dollars" in higher telephone charges. Mr. Lee noted it was going to take some doing to structure the 13% increase so it wouldn't look as if they had "rolled over for the company."

The tape also showed the commissioners, after an initial struggle over how to account for one particularly arcane variable in calculating the rate of return, deciding to jump to an agreement on the bottom-line figure. A FCC official assured them the staff could adjust the remaining variables so the calculation would balance in the end.

When Commissioner Joseph Fogarty quickly moved to grant a 13% increase, Mr. Lee warned: "It's the company figure."

"Yet," Commissioner Anne Jones said, "It really isn't. I mean it is the company figure in one sense, but . . ." she hesitated.

"But it's too low," Mr. Fogarty prompted her.

"That's right," she said.

But Commissioner Henry Quello, who originally had seconded the motion, seemed worried about the consequences. "Is 13 more legally safe than 12.4%?" he asked. Mr. Lee offered a solution: "What appealed to me was 12.5 and a range. You're actually giving them 13, but it doesn't look like you've rolled over for the company."

A range it would be, they decided. "The range thing is public relations," Mr. Quello said approvingly. But the record in the case didn't provide the usual rationale for a range, which is to allow the company flexibility for productivity changes. One staff member suggested another good rationale for a range would be to allow for the volatility of the markets.

Suddenly, Messrs. Lee, Fogarty and Quello disappeared, huddling beyond microphone range. "Wait a minute," Mrs. Jones called out, waving her arms. "Unfair! What's going on over there?"

The men returned. "We have a consensus," Mr. Lee announced. "We would like to instruct the staff to prepare the appropriate documents providing a rate of return in the range of 12.5 to 13."

"Because of volatility, right?" Mrs. Jones said.

"Think up some good reasons," Mr. Lee told the staff. The room erupted in laughter.

—*Wall Street Journal,* October 9, 1981

POLICY REPORT
224 Second Street
Washington, D.C. 20003

SECOND CLASS
POSTAGE PAID
AT WASHINGTON, D.C.

CATO INSTITUTE