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PRODUCT DEVELOPMENT SECTION MEETING

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DR. WILLIAM R. ALLEN: Well, it is true, as you have been warned, that in some circles I am known as the Midnight Economist and then you pause for a moment while the person spits down wind, and it is true also, I suppose, that economics sounds better at midnight.

Professors, you will recall from the heady days of your youth, are programmed to speak for 50 minutes on Mondays, Wednesdays and Fridays and 75 minutes on Tuesdays and Thursdays, and this is a Tuesday! I am used to speaking to a more accountable audience than this, people in their late teens and early twenties and with a rather larger proportion of co-eds. However, rule number one in economics is to make do as well as you can with what you have to work with. That's the teacher's creed. I'm stuck with you and so I will carry on bravely.

I understand the motto of this group is "to live is to die" and some do the latter a moment not too soon I might add. Also, John Maynard Keynes, may his soul rest in peace, whether or not he deserves it, once remarked that in the long run we're all dead. So you can see I'm entering right into the spirit of the organization.

What I have to say will include a fair number of numbers, especially in the first part of the meditations. I suppose that this will strike terror into your hearts, quantification not being the sort of thing you take too kindly, but let me give you a word of reassurance. The reason for mentioning the numbers is not that I expect you to remember them forevermore on the basis of hearing them once. I certainly don't go around memorizing numbers. Occasionally a figure will stay with me for some reason, but I make no special effort to store it into the massive brain, but while you will be given the numbers, it is not then for purposes of your trying to recall them later on, but simply at the moment give you a concrete basis for a feel for the order of magnitude. Instead of my saying something is large or small, why don't I give you some figures, and you can see for yourself about how large or small. So don't be put off by my reference to data. Also, in mentioning real world data, one gives the impression of being relevant in saying things of significance, and that's part of the game.

Well, evidently lots of people, including, decidedly, many politicians and editorial writers, have opinions on and feelings about the federal government budget and its deficit. Those opinions and feelings are divided on the budget, that is, how much and on what government spends and how much and how it taxes, but few have a kind word for the deficit itself. There are, do not misunderstand me, genuine budgetary issues and problems, but much of the discussion is badly structured and directed. The difficulties are not well delineated, so policy options are poorly perceived and policy prescriptions are, at best, suspect. Indeed, one of the major dangers of the deficit is that we will pursue tactics and strategies with such dumb economics and old wives' tales that we will make an unfortunate situation much worse.

Let me say something first about the deficit, its measurement and history. Big and growing federal budgets and budget deficits have become a degenerate way of life, but it was not always so. Over the first century and a half of our independent history, federal spending was a small and quite steady part of national income. It was universally presumed that the budget should be generally balanced. There were occasional bulges in government spending and in government debt during wars, but budget surpluses following wars invariably reduced the debt.

The pattern was shaken by the depression decade of deficits in the 1930s, followed by World War II. There was no whittling down of the debt after the Second World War, but at least the debt did

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not appreciably increase from 1945 through 1960. Indeed, as a proportion of GNP, the debt was cut by more than half in that period, which included seven years of surplus about half the time. It has been a basically different kind of story over the past quarter of a century and more. Since 1960, there has been only one year of surplus and government spending has risen more than eleven-fold; not only proportionately much more than GNP, but absolutely more rapidly than tax receipts.

Compare the decades of the 1870s, the 1920s, the 1970s, and the 1980s. In the days of *Little House on the Prairie*, federal spending was just over 4% of GNP, and each year of the 1870s saw a budget surplus. Half a century later, in the Roaring Twenties, federal spending was still about 4% of GNP, and again, each year was in surplus. But after another fifty years, in the 1970s, the proportion of government spending had expanded five times, to over 21%, of GNP, and each year of the decade showed a deficit, the average annual deficit equalling more than 2% of GNP. The situation has deteriorated further in the 1980s with federal spending 23% of GNP and every year in deficit, the average shortfall being 4.2% of GNP. The average annual deficit after 1960 has been over $65 billion, equal to more than 3% of GNP. In the 14 years after 1974, we have put on a fiscal fiasco. The average yearly deficit of $120 billion has been equal to 4% of GNP. From 1974-1985, spending exploded at an annual rate of over 12%. That rate of expansion means a doubling of spending in only six years.

The government was hardly starved. Tax revenue went up at nearly 10% per year, close to four times the rate of increase of real output. Spending has gone up much faster than tax revenue, but revenue itself has barged ahead at an astonishing rate. It cannot be reasonably said, I submit, that we have taxed ourselves too little. Instead, government has spent too much. Not only have we been on a more than quarter-century binge of ever increasing amounts of collective spending by big brother, but also we have acquiesced in a broadening array of kinds of spending; not all of which has contributed to a prosperous, strong, and tranquil community.

Why the drastic change? Government has long existed. Government borrowing to pay for spending has long been possible and sometimes practiced, so there has long been the possibility of profligate government spending and massive borrowing. Changes in genes and hormones cannot explain why now we do willingly and wildly what we previously had done grudgingly and little. What has changed is the attitude of the people and their government representatives, the dogmas they hold, the mores they adopt, the proprieties they embrace with decreased and still decreasing weight given to personal independence and collective responsibility.

This depressing picture is modified, at least temporarily, by two considerations. First, the federal budgetary history has been quite different over the latest three years, 1985 through 1988. During that brief period, government spending has risen at an annual rate of only 4%, while receipts have risen at 7.4% and the deficit has fallen. Second, the Feds are not the total government. There are states and cities and there has been a combined state and local surplus every year since 1967. Although in the 30-year period, 1948-1978, leading up to California's Proposition 13 and all that, state and local budgets in both receipts and expenditures expanded proportionately much faster than did the federal budget.

Over the six years, 1983-1988, that average annual surplus was equal to about one third of the federal deficit, so the total government deficit has been only some 60-70% as large as the federal deficit. Let me move on to the deficit revenue and spending. The era of great federal deficits began in fiscal 1975. In the preceding dozen years, 1963 through 1974, the average annual deficit was just over $9 billion. But in 1975 through 1986, the average deficit was nearly $116 billion, 13 times greater. It is entirely reasonable to say, as indeed I have already said, that the deficit ballooned not because tax collections were too small, but because government spending was too large. From 1974-1986, the amount of federal taxes came close to tripling, rising at an impressive annual rate of well over 9%. Average inflation was a little less than 7%, so taxes increased considerably in real purchasing power terms. Government spending outdid both inflation and taxation. Spending rose annually at an astonishing rate of close to 12%. As a proportion of GNP, taxes were slightly greater in 1986 than in 1974, but the ratio of government spending to GNP rose by nearly 36%. If spending in 1986 had the same relation to GNP as it had in 1974, the budget would have been virtually balanced. And note I am speaking here of a period of 12 years. I'm not going back to the late middle ages for my comparisons. And while the dollar amount of the deficit has fallen by more than one-fourth since its peak in 1986 and the ratio of the deficit to GNP is now only half as big as it was five years ago, the deficit is still conspicuous.

Well, when faced by a purported problem, it is appropriate to ask about the cause. In some circles, it has become accepted dogma that there have been two critical causes of the swollen deficits of the 1980s. First, government revenue was drastically curtailed by the Tax Act of 1981. Second, government expenditure was drastically increased by defense spending. Both elements of the dogma are a mythology. The Act of 1981 did reduce marginal tax rates. The effect of those rate reductions on tax receipts is not easily measured. A Treasury Department study estimates that the lowered rates will mean a reduction in receipts over the years 1981-1989 of nearly $1.5 trillion. For the eight years, that is an average annual revenue reduction of nearly $190 billion, a little more than the average deficit for those years, but that is far from the whole story. Other legislation has directly or indirectly increased tax collections in the 1980s. Inflation-induced bracket creep, larger Social Security tax collections, and a succession of other tax increases beginning in 1982 have had a combined estimated tax revenue increase from 1981-1989 of over $1.5 trillion. In short, the large tax reduction early in the game has been more than wiped out by all the tax increases.

Not only has there been no abrupt fall in tax collections relative to national income in the 1980s, but the ratio of taxes to income has been remarkably stable for decades. Over the past 35 years or so, since the beginning of the Eisenhower administration, tax collections, as a proportion of GNP, have been between approximately 16.5-19.5%. The relation between taxes and income has remained very steady under both political parties. The tax GNP ratio has averaged just under 18% for Democratic presidents and a bit over 18% with Republicans. The proportion in the Reagan years, about 18.5%, is the highest since World War II. And in the Reagan period, as during all the past 40 odd years, tax revenue has grown more than half again as fast as inflation, so receipts have continued to increase in real terms. We have some fiscal problems, but tax starvation of government is not one of them.

The major mistake in discussion of the budget is focusing entirely on the conventionally measured imbalance of the budget rather than on the size of the budget. The excess of government spending over a collection of nominal customary taxes does have some significance, but all of the government spending is financed somehow and all of the spending sequesters resources from the community or redistributes resources within the community. So the most critical budgetary question pertains to the magnitude of this sequestering and redistributing. How much of the community output is absorbed by or channeled through government?

That critical ratio of federal spending to GNP has risen in every administration since World War II. At the height of the wars in both Korea and Vietnam, about 20% of GNP was represented by government outlays. The peak in the peaceful Reagan years was close to 24%, and the Reagan average was nearly 23%. Cumulative budget deficits were barely greater than zero during the Truman and Eisenhower administrations despite Korea, and they were only 1% of GNP during the Kennedy, Johnson, and Nixon years despite Vietnam. The fat began to fall into the fire, as I had noted, in 1975 with the deficit equalling some 2-6% of GNP in the past 14 years.

Let me underscore two points. First, we have seen that the nominal deficit did not grow to impressive proportions because of tax cuts and faltering government revenue. Second, the striking increase in government expenditures relative to GNP has not stemmed from burgeoning defense spending. The proportion of GNP devoted to defense fell steadily from over 13% in the Korean period of the early 1950s to less than 5% in the late 1970s. The ratio began to rise in 1979 but has averaged less than 6% in the 1980s. The defense ratio was smaller during the Reagan administration than during any other since World War II, except for the Carter period. The primary reason for greater spending has been increased transfer of payments and subsidies, most of which, note, benefit those with at least middle incomes. These programs, Social Security, Medicare, farm subsidies and the like, have grown from about 3% of GNP in 1948 to nearly 10% in 1988. Since the 1940s, we have shoveled progressively more of the nation's income into the government furnace. True, government requires income to provide valuable goods and services that would not otherwise be available. National defense, the administration of justice, and care of the destitute illustrate legitimate, even if costly, functions of federal government. But none of these proper functions has been the wind fanning the fire of federal spending. Indeed the most conspicuous, national defense, has generally declined as a fraction of national output since the Korean War.

Let me note in more detail the matter of national defense. In 1950, federal outlays were less than 15% of GNP. In 1983, they hit a peak of over 23.7%. The average from 1982-1986 was 23.4%. Over just a third of the century then, federal spending, as a proportion of a vastly increased GNP,

rose by nearly 60%. And in the budgetary explosion, there has been a remarkable change in the composition of spending. Whether because of a naive sense of security or a naive sense of foredoomed helplessness in an increasingly hostile world, there was a fundamental shift in emphasis from national defense to expenditures which transfer income from some citizens to others. While defense spending comprised about half the budget in 1960 and transfer payments one fourth, those proportions were reversed by 1981. This reversal meant that in real dollars we were spending less on defense in 1981 than we were two decades before, while transfer payments in the same real dollars grew enormously.

Welfare programs comprise only a small part of transfer payments. The huge and rapidly expanding federal retirement programs, which mostly make up these transfers, largely account for the growth of federal outlays. Currently, one third of every dollar spent by the federal government is for retirement programs, 21 cents for Social Security, over seven cents for Medicare, and that's going to be getting much larger, and 5 cents out of every dollar for civil service pensions and military retirement pay. So don't confuse the two. Transfer payments are not a synonym for welfare. Welfare makes up only a modest proportion of transfer.

In 1960, after Korea and before Vietnam, defense spending was over half the budget, and yet the budget was balanced, actually showing a minute surplus in 1960. Then, from 1960-1986, defense spending increased nearly six-fold, but non-defense spending increased nearly 16-fold, proportionately more than two and one half times as much. What would the budget imbalance have been if non-defense spending had risen by just the same proportion as defense from 1960-1986 with the actual historical government receipts? If non-defense had risen in the same proportion as defense, instead of a deficit of $221 billion in 1986, we would have had a surplus of over $220 billion. Consider an alternative comparison to get some perspective on all this. With the actual receipts in defense spending of 1986, what increase in non-defense spending would have just maintained the budget balance of 1960? The deficit would have been zero in 1986 if non-defense spending had increased only 11 times instead of 16 times. Even that would have been an enormous real increase, for the price level rose a much smaller 3.7 times.

Traditionally, big government but small defense types have complained that large and growing military budgets will ruin the economy. We cannot afford survival. But the historical record has falsified the claim that defense spending has been economically devastating. Since World War II, good economic performance and large defense budgets have coexisted. In the short run, prosperity and defense spending certainly are mutually consistent. Money national income consists of and is measured by total spending, including government spending on output. Spending is spending and more military spending this year will not reduce this year's income. This is not the whole story, of course. We're not indifferent to the composition of this year's output. For a given national output, the bigger the government sector, the smaller the private. And for a given government budget, the more spent on defense for all, the less available to Congressmen to divide among their own projects. Further, the size of the private sector share is one determinant of the amount of saving and the direction of investment. More military spending, while creating income today, could, through adverse effects on long-term productivity, reduce output tomorrow. But the burdens of defense have not been ruinous. Indeed, by obvious indicators of national economic health -- the price level, unemployment, output -- we have done best in recent decades when the military budget was relatively large.

Beginning after the Korean War, compare two 13-year periods, 1954-1967 and 1967-1980. From 1967-1979, the ratio of defense to income fell each year, from 8.9-4.6%, recovering a bit in 1980 with the average just over 6%. By all our measures, the economy performed better in the earlier period, when the proportion of income directed to defense averaged almost half again higher. Real GNP in the earlier period rose 64% compared to 46%. Unemployment was 5.1% compared to 5.7%, and prices rose 33% compared to 126%. Now, this is not to say that increasing defense spending as a proportion of GNP will surely increase output, reduce unemployment and subdue inflation, nor is it to say that, even if one invariably found such correlations, increasing defense spending is surely the best way to promote economic strength. But evidently investment in military survival can be compatible with prosperity. We may even hypothesize that inadequate military investment will not enhance the probability of survival and that failure to survive will not contribute to our prosperity.

Given the record that substantial defense and prosperity can co-exist, it is now sometimes complained that defense spending expenditures are undesirably heightening the economy. For a

perspective on that point, consider the upswing out of the recession from 1982-1984. Annual GNP in that period increased roughly $600 billion. Out of that greater spending on output, the increase in defense was only about $40 billion. It can be added that all government spending expanded by close to $200 billion, nearly a third of the total. The remaining two thirds consisted of greater private consumption and investment. Cost is sacrifice. How much do we forego for our national defense and how significant would be the changes in that cost as the defense budget might be modified? Six percent of our GNP is now devoted to defense, leaving 94% for consumption, investment and non-defense government purposes. Is 6% the optimal output proportion for defense? No one can know, although that share is well below the average since World War II and far below the peak during the Korean War. And so, in a sense, no one can know the proper ratio of defense spending. We must include an uncertainty premium, for defense is the one area of social policy where we dare not underinvest. Whether or not it is appropriate to devote 94% of output to non-defense uses, we can note what would happen to that proportion with alternative assumptions of output growth and of defense spending growth and, with plausible assumptions, very little would happen to the non-defense share of output.

Suppose the GNP grows annually at 2.5% over the next half dozen years. Then if the real amount of defense spending remains constant, the non-defense ratio would rise from 94% to only 94.8%. Even if defense were to fall 1% a year, as appears to be in the cards, the non-defense ratio would rise to just a little over 95%. If non-defense grows at the same rate as output, the ratio, of course, will stay at 94%. That ratio will decrease only if defense grows at a greater rate than output, but the decrease is not much. If, for example, defense expands at 4% while GNP rises at 2.5%, the non-defense ratio will drop only to 93.5%.

Let me move on to the possibility of growing out of the deficit, a contention which has been a source of hearty chuckles in some circles. Almost everyone would like to reduce the deficit. Not everyone wants to increase tax receipts as a proportion of GNP. Some have suggested that we freeze expenditure until revenue catches up. How big a wrench would a freeze be and how long would it take to reduce the deficit to zero? Spending started to grow at an annual average of around 12% beginning in the early 1970s. In 1980, it went up over 17%, and as recently as 1985, it increased more than 11%. That increase was some 50% greater than the rate of inflation. But during the last three fiscal years, 1986 through 1988, government spending has been growing at 4%; only a little more than inflation of 3.3% and much less than the rise of receipts at a rate of 7.4%. We may not anticipate a literal freeze at the current level of spending, but the idea is not now as absurd as it would have appeared about four years ago. With a freeze, it would not take a prolonged period to close the deficit. Government revenue rises at a rate very close to the increase and nominal GNP. The rate of GNP increase is equal to the rate of output expansion plus the rate of inflation. Suppose real output goes up at 3% a year and the price level at 5%, so GNP rises at 8%. If revenue increases at 8% with spending constant, the current deficit of roughly $150 billion would be eliminated in just two years. It is more realistic, I suppose, to anticipate some growth in spending. Suppose the annual growth of spending is held to the inflation rate so spending does not change in real terms. If receipts were perennially to grow any more rapidly than spending, the deficit would eventually be eliminated and then become a surplus. And receipts will grow faster than spending if (A) the spending increase equals the inflation rate and (B) real income grows at all. During the 20th century, over periods of the decade, real income has grown typically at annual rates of around 3-3.5%. So, how long would it take to balance the budget if spending continues to go up at that suggested inflation rate of 5% while receipts rise at 8%? Answer: Slightly over five years.

Next are increased taxation and deficit reduction. If you're not content to outgrow the deficit, how about increasing taxes? Many want to reduce the deficit by increasing tax rates in order to increase tax collections. What are the chances of success? Have past increases in receipts, whether or not stemming from higher rates, reduced deficits? Not always. Indeed, not usually. In the 42 year-to-year observations since World War II, beginning with 1946-1947, federal tax receipts and the deficit have moved in the same direction, almost always both increasing on 20 occasions; about half the time. The record is even more sobering if a lag is noted. In 29 of 41 annual instances, over two-thirds of the time, a change in receipts was followed a year later by a deficit change in the same direction. Commonly, then, when government has provided more tax money this year, government spends it and something more the next year and the deficit grows.

Indeed, there is a strong association between relatively large tax increases in one year and deficit increases in the following year. Fifteen times in the last three decades government receipts have

risen more than 10% in one year. And in 13 of those 15 instances, the budget deficit increased in the following year. In the past 14 years, since 1974, the average annual increase in receipts has been nearly $50 billion, and the average increase in the deficit has been over $11 billion. Over those 14 years, receipts rose at a remarkable 9.3% annually and were three and one half times as great in 1988 as in 1974. The government outlays rose still faster, with more than 10.3%. Government generally will increase its spending by more than the public increases to taxes provided the government.

Well, next, we'll discuss deficits, the burdens of government and interest rates. You see, we get into increasingly racy topics as we go along. In 1982, the then president acquiesced any tax increase. He rhetorically asked, "Would you rather reduce deficits and interest rates by raising revenue or would you rather accept larger budget deficits, higher interest rates and higher unemployment?" The line of thought, such as it is, seems to be, first, increasing tax rates increases tax revenue and reduces the deficit; second, reducing the deficit reduces interest rates; third, reducing interest rates increases investment, output and employment. This is not very elegant economics. The first point, linking tax increases to deficit reductions, is a combination of baseless hope and political deception. The second, linking smaller deficits to lower interest rates, diverts attention from the major determinants of interest rates to a relationship which is very weak and highly uncertain. The third, linking reduced interest rates to expanded economic activity, is a grossly inadequate specification of the conditions of prosperity. Tax rates and tax collections do not invariably move together and we have seen that past increases in tax receipts have not always or even usually reduced deficits. The deficit and interest rates have tended strongly to move in opposite directions.

From 1968-1969, for example, the deficit fell $28 billion, but both long-term and short-term interest rates greatly increased. From 1974-1976, the deficit soared by $61 billion, but long-term rates fell slightly and short-term rates fell greatly. From 1980-1981 to 1986, the deficit rose spectacularly, from $74-221 billion, or $147 billion, but long-term rates fell more than one third and short-term rates more than half. While the deficit and interest rates had been moving in opposite directions, interest rates and inflation have moved together. Meanwhile, interest rates and real output have not strongly diverged. In the past 20 years, interest rates and output have moved in the same direction half the time. Higher rates have been accompanied by higher output and lower rates by reduced output in ten of those years. And interest rates are causally correlated not with deficits, but with the price level. The inflation rate has been greatly reduced and interest rates are far below the peaks of 1980. While changes in inflation have had much effect on interest rates, changes in the deficit have not been accompanied by similar changes in the interest rates and inflation. But go along with the gag. Suppose we presume that raising taxes actually would reduce the deficit and that reducing the deficit would reduce interest rates. After all, the government must pay its bills and if government spending is greater than tax collections, then it must borrow. But when government borrows, it must compete with private borrowers. In the credit market competition, the interest rates are a bit up and private business is crowded out. This has a plausible ring, even if it does not correspond to actual history. But, at best, it can be only a partial story. The private sector can be crowded out of investment as surely by high taxes which reduce cash flow to cash trickle by high interest rates, which inhibit borrowing. Any internal financing is at least as legitimate as external financing. Private saving is at least as attractive as private debt. A dollar earned and not taxed away is at least as good as a dollar borrowed. Reducing the government deficit by the alternative strategy of reducing government spending, or its rate of increase, avoids crowding out through the tax channel. But increasing taxes to pay for continued government spending increases absorption of private cash, while failing to alleviate government absorption of the community's real resources.

I'll tell you a little true life anecdote. An economist who won a conspicuous prize several years ago tried to show that he is hairy chested as well as smart. His subject was the federal budget deficit. He was against it, and to get rid of it, he said that we should stop (using his terms) Mickey Mousing with thoughts of reducing the expansion of government spending and have the guts to increase tax collections faster. The scholar considers deficits destructive to the economy for, as he says, they eat up savings and leave no money for capital investment. Newspaper accounts give no hint of why or how our saving fewer dollars in government bonds, but paying more dollars in taxes, would leave more money for growth in capital. And it was intriguing that the analyst was personally investing in bonds because he expected, in the face of supposedly debilitating deficits, that interest rates would fall. So much for some economists.

Well, next, the budget necessarily balances, but at what level. In the realm of fiscal concerns, it would be far better to worry about the size of the budget rather than the imbalance of the budget. Indeed, in a significant sense, there never is a budgetary imbalance. Look at it in this commonsensical way. *The government acquires things, resources and products of resources.* The government cannot have more than it gets from the people. The community does not give these things to the government. Big brother pays with dollars for what he gets. And the funds with which the payments are made, like the things which are bought, come from you and me; raising the means to make the payment is taxation, even if accountants and statisticians label as taxation only certain of these means. Government acquires the dollars that it spends from the community either by collecting conventional taxes or by deficit borrowing through sales of bonds. In either case, there is a direct wealth reduction for the private sector, and that wealth reduction is taxation. For the economy as a whole, observes Milton Friedman, what is called a deficit is really a form of taxation. The whole of what government spends is extracted from the community's resources, not solely that part financed by what are called taxes. Government spending is government spending, whether government directly gets the funds it spends by handing to the public a tax receipt or a bond. The cost of what government gets from the people is neither diminished nor delayed by any legerdemain or financing procedures. The size of the budget is seen not in the amount of traditional taxes, but in the amount of spending; that is, in the amount of the people's wealth and of the people's income sequestered by and channeled through government. But big or small, no matter how financed, the real government budget is always balanced.

Not all government use of output and resources will be wasteful to be sure. Government may build highways, which not only have value but may be deemed more valuable than what could have been done with those resources by private people. But whether the sequestered stuff is used well or poorly, it is sequestered, so cost is born as less is left in the hands of the private sector. Government financing does involve real taxation equal to the government purchases, whether or not the conventional budget records a deficit. But suppose, to add a bit of detail, that the government spending is not to obtain goods and services. Instead it may be direct income redistribution through transfer payments. In this transfer case, government is not absorbing or channeling the productive use of real resources. There is left with the public no net reduction in loss when Mr. A is forced to subsidize Mr. B. If the public as a whole loses nothing by the redistributive transfer, there is no real taxation, no government extracting of real resources, but then there is also no real spending, and so no real deficit is created. Transfer payments and their financing are only financial operations and shuffling existing assets within the community. In no real sense can a deficit be involved. In contrast, when government buys things, there is a real sequestering in cost, but the real budget remains balanced because the real sequestering fund to the public is also a real taxation of the public regardless of the immediate mode of financing to spending. Many seem mesmerized by the conventionally measured deficit. There are important problems, problems of efficiency and equity, both immediately and over time, associated with the size, structure and financing of the government budget. But to hold simply that we ought to balance the budget provides more confusion than guidance. One step toward clarity in the area of government finance is to note that, in a real and significant sense, the budget always balances.

Whatever the immediate sources of the funds government spends then, that expenditure is to acquire the public's wealth, that reduction in wealth left in private hands, and that is taxation. With government absorption simultaneously matched by private cost, the real government budget is always balanced. But only the private cost represented by conventional explicit taxes is listed in the budget. When those explicit taxes are less than government expenditures, there is a nominal deficit and that nominal deficit, while tending to obscure the perennial balance in the real budget, does have significance of its own. One problem is that tax payments to government are not in the same pattern and proportion as debt, interest and principal payments by government, so government financing redistributes wealth and such redistribution can create community heartburn. Deficit financing implies greater tax payments in the future, but we do not know today exactly who will have to pay how much of tomorrow's explicit taxes. What we can reasonably presume is that the assignment of tax collections, or tax obligations, will not perfectly coincide with the holding of the bonds which are to be serviced and paid off. Taxpayers and bond owners are not identical groups. Indeed, observes Armen A. Alchian, one of the world's eminent economists and a co-author, "If the government bonds each of us held matched exactly the tax on each of us to pay interest and principal, we could simply cancel the government debt." In contrast to private debts, Professor Alchian continues, "When the government issues debt, no one knows definitively and definitely who is liable for exactly how much of the repayment. That impending redistribution to be determined in the future will cause divisiveness and political

instability as we or our children argue and fight like heirs disputing an ambiguous will. That is, I believe, the principal danger of a large government debt."

If current government spending is financed by current taxes instead of government selling of bonds, then the fight over who pays how much of the taxes takes place currently. So there is struggle over the paying of explicit taxes, whether the paying is done now or later. There will be one pattern of redistribution if conventional taxes are levied now. There will be a different pattern if conventional taxation is deferred through sale of bonds. If we are to minimize community conflict, we must reduce government spending and government taxing and the associated government wealth redistribution. There are additional difficulties with a nominal deficit. There could be large deficits with small budgets and large budgets can be balanced, but experience indicates that large deficits are most likely to be associated with large budgets and there is much reason, both economic and philosophic, to fret about persistent increase in the governmental share of the national economy. Further, larger deficits, current and expected, call for funding considerations and practices which, in anticipation and in action, are unsettling. The hopes and fears, especially the fears, of wonderment about government borrowing, taxing and inflating evoke uncertainty, inhibiting long-term planning and adding a risk premium to interest rates.

Still another danger of nominal deficits is inflation and further bloating of interest rates. Inflation, which drives up interest rates along with other prices, stems from creating money too rapidly, and one way too much money can be created is through the Federal Reserve monetizing the debt. The Treasury finances budget deficits by selling government bonds. The Fed can buy these bonds, paying for them with newly created money and at the same time providing commercial banks with the reserves to create still more money. Thus far, in recent history, monetization has not been massive, but the temptation and the potential are. First, monetization reduces the interest-bearing debt held by the public. Second, in substituting money and bank reserves for debt, monetization generates inflation, which reduces the real value of the remaining publicly held debt. Unhappily, government can gain, although the community loses, to lousy fiscal policy abetted by clumsy monetary management.

Well, now that I've painted a happy picture, how about reforms? First, let's discuss flat tax, low tax. The essence of the new idea of the flat tax, which a few have advocated for a long time, is to tax all incomes uniformly. The same tax rate applies to incomes of any amount from any kind of source, with no special deductions, credits or exemptions, except for a personal exemption probably larger than that now in effect to buffer the very poor. The uniform or flat rate may be a little larger than what we have usually looked upon as the minimum marginal rate. However, a flat tax is not necessarily a low tax, for the flatness of the rate says nothing about the level of the rate. Still, very significant advantages are inherent in flat rate taxation. One, it would vastly simplify the mechanics of preparing tax receipts. Two, it would obviate convoluted and expensive tax strategy considerations in spending and investment, which concentrate on saving taxes on current income rather than on producing more income. Three, it would provide the full worth saving and investment incentives of zero marginal tax rates. Four, it would equalize absolute taxes for people with equal incomes and equalize relative taxes for people with different incomes. These four improvements of simplification, productive incentives and uniformity would discourage tax evasion, counteract the growing fear of and contempt for government, and make feasible more than ample financing of government at a minimal tax rate. There are additional advantages. Five, it would eliminate unlegislated tax increases through inflationary bracket creep. Six, it would reduce the expenses of tax collection and the massive interpretive and implementational authority of, pardon the expression, the IRS. Seven, it would neutralize the proclivity of big brother to use tax tactics in social engineering strategy. However, all this would also share status, wealth and power from tax lawyers and accountants and the masses inhabiting tax shelters and government officials. So do not hold your breath waiting for a full-blown flat tax.

How about constitutional mandates? Since there is much concern, some of it legitimate, about budget deficits, there is much talk about how to reduce deficits. One approach, purportedly mechanical rather than political in nature, is to decrease deficits or to decree deficits into nonexistence by means of a balanced budget constitutional amendment. We do well not to let an unreasonable stipulation of protection in an imperfect world preclude progress. Still, the proposal for a balanced budget amendment may have more than its share of problems. One problem pertains to the very objective. To specify only that the budget must be balanced is not to specify a goal which is necessarily very attractive. Our more appropriate concern, be it remembered, is

with the size of the budget rather than with the balance of the budget, with the budgetary level defined in terms of government spending rather than tax collections. A budget can be a disaster both economically and politically because of how much is spent and what the spending is for, even when the budget is balanced. Roy L. Ash, former director of the Office of Management and Budget, reminds us of intimidating technical problems in decreeing budget balance, problems of measurement and our procedure in implementation, and an avoidance of circumvention. What measure is to be balanced? Along with the conventional budget, there are massive off-budget expenditures. We might include housing and other loans and loan guarantees. There are huge trust funds and there are tax expenditures, so-called, exemptions, deductions and credits which are alternatives to direct government spending. And there are costs imposed by the state on the private sector as substitutes for expenditures by government. A different category of competition relates to any emergency override provision. Can such a safety valve be formulated so as to make it immune to Congressional abuse? Mr. Ash notes that we can't constitutionally mandate that politicians must not be creative. Too much interpretive and procedural flexibility would vitiate the constraining purpose of the amendment. Too liberal adaptability would conduce confusion and clumsy paralysis. Even when the requirement of budget balance is combined with a rule for determining maximum taxation, implementation rests on definitions, calculations and estimates, along with Congressional integrity, which leave effective constraints largely uninteresting. Finally, if the provision of a balanced budget amendment were, unsurprisingly, violated, who would do what to whom? What could be the channels of redress and remedy? It is a disgrace that there is occasion for ingenious proposals to impose responsible fiscal policy by constitutional mandate. The policy problem stems ultimately from cowardice, banality, and demagoguery. Given the disgrace, it is a frustrating shame that an appropriate amendment, which first seemed so straightforward, is, in fact, so complicated in formulation and uncertain in effect. Lack of character in high places makes life harder than it need be.

How to contain government spending? One proposal is to give the president line item veto authority for appropriations bills. Some bills appropriate tens of billions of dollars in dozens of spending categories for several government agencies. But the president faces an all or nothing choice. He either approves or vetoes the entire bill. It may seem reasonable to permit the president to be selective in approving or vetoing individual items in a massive heterogenous appropriations bill thrown together by log-rolling legislators. Forty-three states have given that power to their governors, but objections have been offered to the item veto proposal. It is complained that the great bulk of the budget is effectively beyond the reach of veto or of any other kind of discretionary control. Payment of interest on the debt, for example, is not legally optional, and most entitlement payments seem not to be politically optional. Use of the item veto might level off only a minute portion of the budget. Still, a billion here and a billion there does add up. As a Heritage Foundation study notes, an annual 1% cut in the budget beginning in 1975 would have reduced 1985 spending by over $100 billion, equal to half the deficit. But anyway, it is a peculiar argument against adopting a procedure to say that the procedure would not encompass enough.

Other objections to the veto proposal are mutually incompatible. It is said that presidents, despite their persistent requests for item veto authority, do not really want it and would rarely use it. At the same time, we are told, granting the authority would greatly and maybe undesirably shift power from Congress to the president. The first concern largely negates the second. Authority little used cannot be power greatly shifted. It has been complained that the proposed procedure would be used, but not in ways intended. On the one hand, a grand standing Congress might load bills with pork for the president to cut, but if the political price of cutting is deemed too great, spending would be allowed to increase. On the other hand, a blackmailing president might use the threat of selective veto to cow a cowardly Congress for his own purposes, which are likely to be expensive. So the item veto authority would not greatly reduce spending quickly and it is conceivable that it would perversely lead to congressional or presidential irresponsibility, which would increase spending. Still, the budget is a growing mess. Modifying the budget-making procedure with delegation of presidential item veto authority could be of only marginal help, but in a messy world, most improvements are marginal. Some improvement is better than none, and potential gain is better than assured continued deterioration. And I end on that happy note.

MR. SHANE A. CHALKE: We do have some time for questions, so if you will indulge us and remain up here, fire away.

DR. ALLEN: I had meant to stall and filibuster enough so that there wouldn't be any time left, but I failed miserably, so I am putty in your hands. Do with me as you will. Yes, sir?

FROM THE FLOOR: (QUESTION INAUDIBLE)

DR. ALLEN: Well, wouldn't you know. A bunch of actuaries, if they had to choose in their interest between sex and interest rates, they choose interest rates. It's that kind of group. Well, I would answer now the same way I would have answered ten years ago and the same I would answer ten years from now, if you actuaries will let me live that long. What we surely ought to have, and there is growing consensus on this, even the fiscalists, the Keynesian type economists, are more and more granting this point is a monetary policy which increases the amount of money at a low steady rate. How small should be the rate of expansion of money? Well, this depends on some other variables because there certainly are things which affect prices in addition to money. No reputable monetarist has ever said that prices and money move together hand-in-hand perfectly well. It's a matter of historical record that the correlation is less than perfect. Or if you don't want to correlate prices with money, nominal GNP with money, whatever you're comparing, the relationship between that variable and money is less than perfect. But there is a conspicuous level of correlation and how low is low then? It depends on such things as the velocity of monetary circulation, which for a long generation, from the very end of World War II up until the early 1980s, rose quite steadily, little trickles to be sure, but if you stand back and close one eye and squint with the other the time series goes up virtually a straight line, at around 3%, 3.5% a year.

Since the early 1980s, velocity has been essentially zero; actually a small negative change, which is actually quite convenient. I mean, the non-monetarists, the hold-outs from truth, had chortled that the money price or the money income linkage has been broken because of the misbehavior of velocity. Well, it always, in terms of model building and using summarization, was convenient to say, suppose velocity was zero. It isn't, but if it were, then we'd have such and such results and then you had to go back and modify. Well, now, for the 1980s, velocity pretty much, not literally, has been zero. Well, fine. Now things work out more neatly than ever before. Tell that to your local editorial writer who has not yet caught up with that truth. So if velocity is going to approximate zero, then you would have stable prices if the money supply increased at the same rate as real output. Well, real output, as I mentioned earlier, has traditionally, over more than a century, gone up at an average annual rate of around between 3% and 3.5%; 3.3% actually. So that's the rate at which money ought to go up; between 3% and 3.5% a year. Now, suppose you adopted that monetary rule that year after year, come hell or high water, money is going to go up at 3-3.5% a year and you implemented it, made it effective. Would that then result in perfectly stable prices? By stable prices I mean, of course, stable price level. Individual prices will change. That's the way the economy works, changing relative prices, but would the price index remain stable or would the increase in money equal the increase in real output? And the answer is no, no. There are still going to be jiggles. Why? Well, because there's still a fourth variable. I mentioned money and velocity and prices. There is output.

If the amount of money increases at a steady rate and velocity does not change, then expenditure increases have a steady rate, but if output increases erratically, then prices will move in virtually indirect proportion to output. If you have big harvests and a big output in a year, but spending still goes up at the same 3% or 3.5%, then prices would fall. Lower output in a given year, prices would rise. So there would be some fluctuation of prices, but it would be within, oh, just to illustrate the point, say 2% above or below zero, within that range of 4% points. And that would be a vastly better performance than we have had historically when it's been between, say, minus 7% and plus 15% or 17%. The range has been fully 20 points in recent years. Now, you may say, Well, okay, so that would be an improvement to have a swing or a range of 4% instead of 20, but we idealistic sorts don't want to settle for second best. Can't we hit it right on the nose? Couldn't we jiggle the growth of money so as to offset or counterbalance the jiggles in output so as to maintain the price level quite literally at a plateau? And the answer is no, you can't. It would be nice if you could. You can't. No matter how great you are, how clear the mind and how pure the heart, that is not feasible. Now, that would be a big topic to go into. Take it on faith, of which you have an abundance. Operationally, that cannot be done. We cannot do that sort of fine tuning. Now, that word hasn't gotten out in all circles either. There are those who, to use Rexford Guy Tugwell's New Deal remark, want to roll up their sleeves and make over America, and they want to sit there pulling those levers and twisting those dials so that everything comes out perfectly on the nose. Not only will they not get it right on the nose, but the pulling of the

levers and the twisting of the knobs almost certainly are going to bring about bigger fluctuations than we would otherwise have. So second best, in this context, is really the very best we can have. And I'll settle for it. It's been a lousy world ever since the fiasco in the Garden of Eden. If we can hold the fluctuation in the price level within 4%, I'll live with that gracefully.

FROM THE FLOOR: (QUESTION INAUDIBLE)

DR. ALLEN: The international or balance of payments deficit complicates life for me only because I have to answer questions on it. Otherwise, I don't worry about it. It is a topic of discussion and it serves that purpose. Otherwise, we'd just sit here, although I understand that's the reception Lincoln got at Gettysburg, and we all know what happened to him. No, I'm not worried about the balance of payments deficit. We talk about a deficit in the balance of payments. Well, what does that mean? You're comparing something with something in order to get a discrepancy between the two numbers. Lots of people, journalists and politicians in particular (I guess they're people) look at merchandise trade. Well, that's only a part of the picture, a very large part, but far from the total. Others? We'll throw in services along with goods. That's still only part. Some will throw in investment income, dividends and interest. That's still only part. By now, we're talking about what is usually called the current account in the balance of payments. Well, but even if, whatever the precise measure you use, by that measure you have a deficit so that imports are bigger than exports, does that mean the balance of payments as a whole is not in balance? Of course not. It's double entry bookkeeping. Each transaction is balanced, so of course all of the transactions together balance. If we have an import balance on goods and services, using the term broadly and loosely, it must mean that we are exporting IOUs. We import goods. We export securities in some sense, which is called, rather confusingly, an import of capital. An export of IOUs is an import of capital. So the import of goods and services is, on balance, being financed by the import of capital, which gives a different perspective on things. It means that the rest of the world is investing more here than we are there. Well, in a way, wouldn't you kind of worry if it were the other way around, as it has been, of course, for long periods? I mean, the world, meaning both foreign investors and investors in this country, has found this economy to be a very attractive place to put its capital; more attractive than in most of the rest of the world. Well, now, is that something to hang our heads in shame about? Should we be embarrassed about it? Should we be fearful because this is an attractive economy, one with good prospects, one with good rates of return, one with stable property rights?

Actually, as a footnote, the great inflow of capital, as registered in the balance of payments in the mid and late 1980s, did not, however, result from some massive inflow of foreign capital. Or to put it the other way around, it wasn't that American residents suddenly were borrowing more from abroad. That's the way it's usually put. We are borrowers rather than the rest of the world being investors because that puts the emphasis the way you want it. You want to balance sack cloth and ashes, right? I mean, the warm inner glow of futility in our ineptitude. People live on that. America last. But we have increased our borrowing.

Well, I've already addressed myself to the first aspect. I can put the emphasis on the rest of the world investing here rather than putting it in terms of our borrowing from them. Secondly, there has not been a big splurge of foreign investment in the U.S. It's been rather more a case of a reduced capital outflow from the U.S. to the rest of the world. The data are there. I'm not making it up. You can look it up. And why this? How do you account for it? Well, what was going on in the world in general, in the mid-1980s in particular, not just Latin America and Africa, but western Europe as well? They were having a very tough time. It was not a very attractive place to put investment funds, and so American investors started to cut down on their investments abroad just as, and in part for the very same reasons, foreign investors liked what they saw here. So on balance, there was a big increase in capital inflow. Well, I don't find this to be reprehensible or to constitute damnation. We get their capital, we get their savings, and they get pieces of paper from us and you can write a very big number on a small sheet of paper. It doesn't cost much to make the paper and we get their resources in return. To say that we have an inflow of capital is to say, and this goes back to the beginning of my remarks, that we have an import balance on their goods and services. So we're getting their savings and their goods. We have the rest of the world working like so many beavers for us. I think that's great. I revel in it. If we could just do more of it. If we could con these foreigners (and you know they're foreigners because they have beady little eyes set too close together) into working just as hard as they could to supply us with their output and take nothing in return so that our imports ballooned and our

exports fell to zero, why, we could all spend the day at the beach. We could live high off the hog, the hog being produced by all the rest of humanity.

Let me add just a footnote to that. That was the essence of my reply. As a kind of an accounting detail footnote, and I know you run through accounting details in your bare feet every night for kicks. That cat has been let out of the bag already. Are we a debtor? It's one thing to talk about an inflow of capital in a given year or over a short period, but the international creditor/debtor status is a result of all history and you can't tell that from the balance of payments of a single year. But what about the result of all of history? Are we a debtor? It's a common place. It has been for a couple of years. We're the world's greatest debtor and everybody shakes his head dolefully and kind of lowers his eyes in shame. It's an open question as to whether or not we're a debtor at all, much less the world's biggest, and whether or not it's important that we are a debtor or the world's biggest. It's not a sure thing because of the way the numbers are kept. Granted if you have a capital inflow long enough, eventually, of course, or by assumption, you will become a debtor. Whether or not we reach that point is not a sure thing. If we have, it almost certainly has been only within the last year. I'll not go into details on it, but I assert it and I could elaborate a bit on that.

I will add a footnote to the footnote. You're not one of the boys in my business unless you have footnotes to the footnote. And that is that the international debtor/creditor situation can be broken down into certain categories. I mean, there are different kinds of debts and credits. In terms of direct investment, as the term is generally used, real estate and buildings and that sort of thing, real assets, we're still a creditor. I mean, even the official numbers say that. The amount by which we are a creditor has fallen appreciably in the last six or eight years, but we're still a creditor on real estate and that kind of thing. Where we have supposedly become a debtor is on portfolio investment. People have bought more securities, government and private, in this country than American residents have bought abroad. But again, is that really evidence of economic decadence? We may be decadent, but I don't think that in itself is very good evidence. That's not a good indicator. We prefer, we meaning the world in general, both American investors and foreigners, to put our funds in American claims rather than in non-American claims.

Well, I hope I've said enough at least to suggest why I really don't take the balance of payments to be a very serious sort of thing. It's simply a device to give occupation to some accountants and statisticians, footnote to the footnote to the footnote, especially if you have fluctuating exchange rates. If you let the exchange rate free, and it is a price that's determined by supply and demand in the market, something is being bought and sold at a price. That's what a market is. If you let the market determine the market clearing level of that rate, then who cares or who should care about the balance of payments? And the answer is no one, no one. Let nature take its course.

I would throw interest payments, and they have become conspicuous in the last several years, under the same category as I talked about with transfers. That is, there are some people in the community who hold their government bonds, the people in institutions. The government gets money in one way or another and they pay off the principal and the interest. It's a transfer of payments. It's a shuffling of claims. And if it were the case, as I was suggesting, that if people held government bonds in the same proportions and the same kind of pattern as they pay taxes, then on balance really nothing happens. You would pay for the interest of government and then they use those. Not interest. You pay taxes to the government. The government uses those tax receipts to pay interest on the bonds. You pay out $100 and you get $100 back. Nothing really has happened. In actuality, of course, people don't hold government securities in the same pattern as they pay taxes, so there is income redistribution. But I put that under the same general category of other things I talked about; this is a significant fact. I acknowledged it was significant of the nominal government deficit in debt, that there will be income redistribution. Income redistribution not based immediately and directly on productivity or changes in productivity, but simply a transfer of payment and I'm not very happy about that. The ideal economic system surely is that basically and typically, though there can be exceptions for those who can't compete, you are paid on the basis of what you produce. But here is an instance where you have redistribution of income on other bases and that's a problem. But I think that's about the extent of the problem.

FROM THE FLOOR: *(QUESTION INAUDIBLE)*

DR. ALLEN: Lots of people talk about the low savings rate. Actually, it's exceedingly difficult to measure it. There are measures, but they don't say the same thing. The Federal Reserve has one measure, the Department of Commerce has another measure, and they're not even in the same ballpark. They're just enormously different. It depends on all sorts of things as how you calculate it, and different countries do it in different ways. There was a piece in *The Wall Street Journal* a couple of years ago or so comparing the Japanese saving rate with the U.S. saving rate. Well, as the numbers are usually thrown around, it's what, 20%, 22% or whatever for Japan and 3% or 4% for the U.S. In actuality, if you calculate them in the same way, this isn't feasible to the fourth decimal place, but if you make the best approximation you can, the rates are very, very similar. There's no appreciable difference between them. So I suppose that what I'm saying, or one of the implications of what I'm saying, is that it very likely is a mistake to worry about the detailed specified problem of something like a saving rate. Or interest rates.

You get into trouble when you select a closely defined problem and center on that as though it's there in isolation, and one consequence of this selective concentration is that then you begin to try to devise policies and strategies to be carried out by government to do something about the supposed problem. The problem actually may not even exist, as I have suggested with the international indebtedness situation, and it may not be nearly the problem with regard to the saving rate that most people presume. But whether or not it exists, whether or not it's a big problem, here's taking it up. You've devoted your time to it. You've gotten a forum. People are listening to you. You want to talk about this problem in isolation, and so you devise strategies which impinge directly and immediately on it, and you're right away almost certainly in trouble because that's not the way the world works. The way the world works is with all sorts of things being functions of all sorts of other things. Indeed, ultimately everything is a function of everything else. And I think we'll be better off or get better results if instead of trying to pick out specific problems to concentrate on, we look at the rules of the game and the context in which it's played in general. It goes a long way to summarize what I'm saying if you put it in terms of property rights. Property rights essentially are the ground rules under which we play. Property rights specify who has what control over what assets. Property rights are never complete. All these rights are subject to some restriction. I have a hammer. It's my property. I can do with it as I like, except that I can't break your window with it, that sort of thing. So they're always restricted, but property rights specify who can do what with what assets. And having once established the rules of the game, then you let all of these myriad decision makers, who know their own individual positions much better than can any one person or any one agency or department in Washington comprehend, make do and adjust and roll with the punches and maximize their own position, given their options as they view those options.

I think that's the very essence of an efficient economy. It's also a description of a private property, price directed, constrained government economy. So I'm not going to fret greatly about the saving rate, per se, in isolation as such. I do fret about those things which may impinge upon the savings rate, along with impinging on lots of other things. I have in mind such things as taxation, which does not encourage saving, which penalizes it. The Japanese, as I understand, do not put any tax at all on savings, and they do not tax capital gains at all. Several other countries do not, but you come to the conclusion, or at least it is suggested to you, that you ought to have very low or zero taxation on things like savings and capital gains, not by approaching those topics directly and immediately, but rather by considering what kind of society do you want, what should be the nature of the ground rules, how should decisions be made as to how scarce resources are used. And if you start off with this kind of perspective, then that in turn generates the questions you ought to be concerned with; whereas if you don't have the orientation, and most politicians and editorial writers don't, then they fall in the trap of taking up problems in isolation one at a time and that creates enormous difficulties. But this is, if I may say so, fairly subtle. I don't mean that one has to be a boy genius to grasp it, but you're not born with this kind of perspective and in our work-a-day worlds where almost everyone is a specialist of some sort, the temptation is very great to go at problem-solving in the public policy arena in specialized fashion. But whereas people, I think, typically are pretty shrewd when it comes to handling their own affairs within the context of their own activities, they're not professional analysts. They have not been cultivated as decision makers and problem solvers. They have no degree which says that they are officially educated. So, by gum, when it comes down to taking care of me and mine, given the options available to me, most people tend to be pretty shrewd. But once they get outside of that arena of expertise and experience and try to talk about the balance of payments or interest rates

or savings rates or whatever, they're talking about things about which they quite literally know next to nothing, and they can be greatly misled by the editorial writer and the politician, even by the economist in some cases.

FROM THE FLOOR: I have one question on medical care inflation. That seems to be the principal cause of a large part of our problem. How would you control that?

DR. ALLEN: Well, I'm not sure offhand what track I'm supposed to follow. I suppose one way to solve a large part of the problem is to do, as I believe the Spartans did, and leave the old and unwanted young on the mountainside overnight and that would save resources. As a matter of fact, though this may not be precisely the sort of thing you had in mind. I think it has some pertinence. The treatment of the elderly is it seems to me, getting kind of weird. For a while, the elderly were a favored group. Social Security benefits were vastly, if not indeed irresponsibly, increased. This is a real mess. I do not suppose that the problem of Social Security had been solved. At best, it's been put on a back burner for a while. But by the time most of you are at my age, it's going to be very conspicuously a problem again and even more severe perhaps than it has been in the past. I won't worry about that. I won't be with you then, but you ought to worry about it. But after being the favored group for a while, now apparently the idea is to debauch the old. It's reached a point where the marginal tax rate, the marginal aggregate taxes paid by the poor can be over 100%.

A good friend of mine, a very competent and well-known economist who retired two or three years ago from First Interstate Bank, wrote and said that he calculated his marginal tax rate now as 90%, and there are instances where it's been over 100%. One major reason for this is, of course, they take away some of the Social Security benefits for extra income; take away one dollar for every two additional you earn currently. I understand that it's going to be one for three next year, so that will help a bit. But one for two, that in itself all alone is a 50% marginal tax rate. And now you have the Medicare surcharge for something on the order of 40% of the more affluent retired. This is going to add a good many percentage points as well. The Social Security benefits are taxed and then there is the regular federal income tax everyone pays. There are state and local income taxes everyone pays. You add it all up and in some cases it will be 105%, 110%. You'd be better off earning less rather than more. Well now, it seems to me that sort of thing, and Medicare is a conspicuous part of it, has a moral dimension. Economists typically are amoral, some of them even immoral, but as economists they are amoral; that is, they don't sit on Mount Olympus and pass judgment on what you ought to like and what you ought to reject, but insofar as even the economists may be allowed to pass judgment on what is right, what meets the test of propriety? It seems to me really pretty peculiar to tax people above 65 or so at 60%, 80%, or 100% at the margin.

Second, and this is more germane to the realm of the economists, it is productively idiotic. We want to have more output surely. It's a world of scarcity. We live higher off the hog when we produce more. Manna from heaven is in very limited supply, and how do you get people to produce? The old produce very large for the same sorts of reasons the young produce; namely, they're rewarded, as indeed seems entirely appropriate. If you're going to tax them 80%, 90% and 100% on every additional dollar they produce, the amount of production surely is going to fall. Now, it seems to me that kind of policy is utterly insane, totally irresponsible, even if you throw out the morality and the propriety of it. It just makes us a weaker nation, and as more and more of the community is going to be above 65, (something on the order of a fourth of the population, I understand, will be over 65 not long into the 21st century), are you just going to wipe out the productivity of 25% of the population which, of course, means more than 25% of the productive part of the population? You're wiping out maybe a third of the potential productive part of the population. Is this the way to compete in the world in having a strong and prosperous nation?

But as for medical care in general, I add just this. The downward sloping demand curve is the most fundamental axiom in all of economics; the lower the price, other things the same, the greater the quantity demanded. If you lower the price of medical care, there will be a greater quantity demanded. This doesn't mean that old people or any other sorts of people are greedy and grubby, and they are of course, but not in any unique sense and you don't rest it on this ground alone. Naturally it's rational, perfectly reasonable and therefore predictable. You lower the price of something, you get more of it, whether it be medical care or poverty. And so when you subsidize medical care heavily, undoubtedly a large part of this huge bill, (11% or something of GNP) goes into medical care now. Now, that in itself doesn't mean it's bad. Maybe that's optimal,

at least in your own view. Maybe health is so important that we ought to spend that and more of the social output, but in any case, it's going to be more rather than less the more you subsidize it and this is inherent. It's inherent in poverty programs. I am, most assuredly, not suggesting that you wipe out poverty programs. I've eluded to this before, that is not my point of view. But inherent, in a poverty program is the problem of how you maintain productive incentives while helping those you want to help. And I don't think there is a very good, satisfying answer to that question. The best we can do is to minimize the cost. But, of course, that's good economics.