

**Weidenbaum Center on the Economy, Government, and Public Policy
Breakfast Presentation**

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Confessions of a Nuts-and-Bolts Economist

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I am delighted to see so many friends gathered to celebrate the publication of my new book, *One-Armed Economist*. A more accurate title would have been, “Confessions of a Nuts-and-Bolts Economist.” Indeed, I am not here to present any grand new vision of the role of economics or of economists.

Rather, my purpose — today and in the book — is to show how useful it can be to combine a modest amount of economic analysis with lots of experience. I try to keep in mind the legendary plea of President Harry Truman: “I’m tired of economists who say, ‘On the one hand . . . and then on the other hand.’ Send me a one-armed economist.”

The key economic questions that bedevil our fellow citizens are of longstanding. I will try to deal with some of them today: How can we improve the performance of the economy? How can we simplify the tax system and reduce waste in government? Can we do something about the explosion in health care costs? How can we reform corporate governance? Can we say something new and useful about government regulation? How much defense

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can we afford? Should we worry about the trade deficit? Is globalization a boon or a bane?

Let us now take up each of these issues.

Innovations in Economic Policy

Effective economic policy must go beyond conventional monetary and fiscal measures, important as they are. We need to improve the basic structure of the economy so that it can function better in good times as well as bad. We must remove the barriers that prevent us from achieving a pace of economic expansion that is both more rapid and more durable than our customary experience.

Many of these structural defects arise from the operation of government policies and programs. Let us focus initially on two major categories: the composition of government spending and the structure of taxation. Reforms in both categories can be designed to further more fundamental economic objectives. The array of government programs that affect the economy is staggering — and also a basis for serious budget cutting.

Five guidelines can be helpful for improving the way that government spends our money:

- (1) Focus budget cuts on the large consumption part of the budget (what the public accurately calls handouts) rather than on the small investment portion. Investments in schools, roads, airports, libraries, and fire stations raise the efficiency of the economy in the years ahead. Transfer

- payments (that is, handouts) do not generate such a future flow of benefits.
- (2) Target for cutback the subsidy programs that benefit limited groups of the society. I favor equal treatment of farm subsidies, labor subsidies, and business subsidies — cut them all out.
 - (3) Avoid spending programs which merely offset problems caused by regulation. The sensible alternative is to correct shortcomings in regulation directly.
 - (4) Privatize all those activities that are properly the responsibility of the private sector. Why should the Government Printing Office compete against Rand McNally in selling maps to the public?
 - (5) Use economic efficiency as a basic factor in deciding what programs should be in the budget and which should be out. The constant question facing the governmental budget reviewers should be, “Is there a better way of achieving the public objective?”

The most fundamental — and desirable — reform of the present tax structure is to shift the base of federal taxation from income to consumption. Such a change would encourage saving in our economy which is so short of saving. By generating more funds to finance investment, a consumption-based tax would ultimately result in a more rapid rate of economic growth and a larger income pie to distribute. Moreover, it is possible to make such a basic change while dealing with the concern about fairness in the distribution of the tax burden.

The most practical way to proceed is to modify the existing personal income tax form to allow the taxpayer to deduct saving from reported income.

Unlike a conventional sales tax, this method avoids the need to tax individual purchases. Of especial importance is that this approach to reform, unlike a regressive sales tax, also retains the opportunity for using a progressive tax schedule. That is the key to ensuring the fairness of the federal revenue system.

Looking ahead, the major challenge to the federal budget will be financing health care. Every recent study shows that the medicare trust fund will run out of money long before the social security program — and the cumulative deficit will be much larger. What is required is not tinkering with the existing program but to introduce real economic incentives into the way that health care is paid for.

The most effective way to do so is to reduce the dependence on third-party reimbursements. Right now, the prevailing view can be summarized in a simple statement: “Nothing’s too good for me, especially if I don’t have to pay for it.” For the typical middle class patient/consumer, it makes no sense to go through an expensive insurance/reimbursement system for routine office and out-patient hospital visits and procedures (e.g., flu shots).

Health insurance should become a true form of insurance which protects people from chance but devastating illnesses. My auto insurance does not reimburse me every time I change the oil on my car, even though that is important for the life and safety of the vehicle.

As long as patients view health care as a “free” entitlement, the prospects for effective cost control will be dim. We also should remember that the status quo is not of ancient vintage. As recently as 1960, patients (and their families) paid about one-half of their health care costs. In olden times — when I was a youngster — the typical family paid directly for most medical services.

Applying Economic Analysis to Business Issues

Turning to corporate governance, it is important to restore public confidence in the private enterprise system. That is not a task for government. Rather, the most effective way of restoring confidence in business is for companies to do so themselves. Many corrective actions already have been taken. I do not mean all of the paperwork resulting from complying with recent legislation such as Sarbanes-Oxley. It is not an attack on that well-intentioned law to note that — under current circumstances — a mere announcement by a company of an overstatement in its financial reporting results in a drop in its stock value.

Clearly, the investment public has become sensitized to departures from truth-in-reporting. Nevertheless, it is healthy for the private enterprise system to see business lawbreakers go to jail. And there is no shortage of laws already on the books.

Reforming Government Regulation

Let me turn to an area of public policy where real progress has been made, but where substantial further improvement is needed: government regulation of business. Not that long ago, a notion was common that the costs of government regulation should be of little concern to citizens because they are paid by business. However, it is now widely understood by professionals, both liberal and conservative, that regulation is a hidden tax.

That tax may be initially imposed on business, but it is ultimately shifted to the consumer. Because of its off-budget nature, the cost of complying with government regulation often is downplayed in favor of the benefits that may be generated. As we have shown, those costs are pervasive, affecting taxpayers, employees, investors, homeowners, as well as consumers. Sensible public policy does not ignore either the costs or the benefits. It takes account of both.

A powerful reform weapon has been the power of ridicule. Our research has shown that regulations often deal with the most trivial questions: What size to establish for toilet partitions? How big is a hole? (as opposed to an opening). When is a roof a floor? What colors should exit signs be painted? How frequently should spittoons be cleaned? When our reports moved the subject of regulation from the exclusive domain of the scholarly journals to the cartoons and comic strips, I knew we were making progress.

A fundamental conclusion is now widely accepted — government regulation is complex and it generates costs as well as benefits. That sounds so basic that we have to wonder why it took so long for the idea to sink in. One major policy recommendation has become standard: subject proposed regulations to benefit/cost analysis. That requires governmental decisionmakers to consider both the advantages and disadvantages and also encourages them to seek more cost-effective approaches. Benefit/cost analysis of proposed regulations has been adopted by every administration, Democratic and Republican, since President Ford.

Benefit/cost analysis is not a matter of dollars versus people's lives. My favorite examples of successful benefit/cost analysis of regulation do not use

dollar signs at all — but put people on both sides of the equation. Here are a couple of examples.

Remember the outcry about using nitrites in meat. It turns out that nitrites can pose a very mild carcinogenic hazard. However, an outright ban would have generated many more cases of deadly botulism. Common sense prevailed. Nitrites were not banned but the users were urged to minimize the amounts used.

The case of asbestos in brake linings had a similar happy ending. Asbestos is a known danger in the workplace, but the product is an essential component of brake linings. Rather than banning the product, employers are required to take a variety of actions to protect workers using the material.

Understanding the Military Economy

The most heavily regulated part of the American economy is the defense sector, but even specialists in regulation ignore it. That is so because no formal regulatory agency exists for the companies producing goods and services for the military. The mechanism for regulation is indirect but powerful. Government is the monopoly buyer of military aircraft, missiles, tanks, etc. The standard military procurement contract contains a staggering array of non-negotiable government-imposed requirements on the private firms who serve as government contractors.

The last time I checked, the Defense Acquisition Regulation contained seventy parts, twelve appendices, two manuals, and six supplements. Some of these details border on the trivial. For example, the safety rules followed in the offices and factories of defense contractors must be consistent with the latest

edition of the Corps of Engineers safety manual. Also, in producing aircraft tires and tubes, the contractor must buy an amount of rubber from the government's stockpile equal to at least 50 percent of the value of the contract (such tie-in sales in the civilian economy are illegal).

To ensure that its procedures are followed, the military occupies a suite of offices in each defense plant so as to ensure full-time access to company decisionmaking. Approximately 40 officials have review power over the decisions of an individual manager of a military procurement program. Numerous shortcomings have resulted from this bureaucratic relationship, especially large cost overruns and delays in innovation. Radio Shack often has more advanced products than those incorporated in currently produced weapon systems.

Sensible reforms include streamlining the Byzantine array of military procurement rules. Does Congress really need to get into such detail as prohibiting defense contractors from importing anchor chains?

A recurring question relating to defense economics is how much can the United States afford to spend on defense. The answer should start with an acknowledgement that the economic health of the nation does not require any particular level of defense spending. If consistent with the national security, a shift from military to civilian outlays will generate a more rapid rate of long-term economic growth. However — and this is my basic point — within wide limits the United States can afford to spend as much on national security as the nation feels compelled to. A quotation from Adam Smith is relevant:

The first duty of the sovereign, therefore, that of defending the society from the violence and injustice of other independent societies, grows gradually more and more expensive, as the society advances in civilization.

Dealing With the International Economy

Finally, let us turn to the international economy. The ongoing debate on globalization could benefit from more light (information) and less heat (emotion). The modern economy has become pervasively globalized. To cite an everyday example, a “Japanese” product, the Honda Accord assembled in Marysville, Ohio, contains a greater percentage of U.S. value-added than do some models of cars sold by such “American” firms as Ford and General Motors. The internationalization of production was nicely summed up in a cartoon: The customer asks the auto dealer, “Is the car made in the United States?” He replies with another question, “Which part?”

The huge U.S. trade deficit with China has become a popular subject for political debate. But candor requires us to admit that the United States is running a trade deficit with most nations with which we trade. In reality, the continuing trade deficit is a symptom of a more basic economic imbalance. Americans invest more than we save and we consume more than we produce. The investment gap is filled by importing substantial amounts of capital from abroad. What do we do with the foreign money? We buy their goods and services. The result is a trade deficit — which allows Americans to consume more than we produce.

This explanation simplifies a complex reality, but it is correct in its fundamentals. Moreover, this explanation points us in the right direction in terms

of public policy: we can reduce the trade deficit in a constructive and sustainable manner — not by erecting barriers to imports or subsidizing exports — but by encouraging Americans to save more. This gets us back to where we started, domestic tax policy.

Final Point

In lieu of a summary, I will conclude this survey of the role of economics in public policy by citing a passage from the presidential address by Sir Dennis Robertson to the Royal Economic Society:

I do not want the economist to mount the pulpit or expect him to fit himself to handle the keys of Heaven and Hell . . . I want him to be rather humble . . . I like to think of him as a sort of “Good Dog Tray.”