THE GOVERNMENT'S STAKE IN ECONOMIC INSTABILITY

Paul Craig Roberts

I would like to take the opportunity of having the last word to add some perspectives to those that have been discussed today. It may be that what we see as problems in economic stability actually represents maximizing behavior on the part of the government.

From the perspective of social welfare maximization, we see the government doing all the wrong things. But what looks like failures from this perspective may not look like failures to the government itself. It may see successes because, if you think about it, economic instability expands the role of government. Inflation produces revenues for the expansion of government programs. According to the Joint Committee on Taxation, for every one per cent rise in the price level, the government's revenues go up by 1.6 per cent. So inflation is welcomed by people in government who want to spend more. Private sector unemployment expands constituencies for public service jobs and for public works, and so, what we see as problems may be seen by government policymakers as successes. There is a dichotomy in the economist's behavioral assumption. That is the great failure in the public finance and public choice literature. People in the private sector are assumed to maximize

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their self-interest, while people in the government sector are assumed to maximize the public's interest. The self-interest of government is left out.

We must take into account that the government benefits from economic instability -- not a lot of instability, for if it gets out of hand, those who have power will be displaced by somebody else -- but a certain amount of instability is beneficial to the government. As far as I can tell, the power of Congress depends on handing out things and doing favors. When there is instability, it gives Congress more opportunities to do these things. Everybody is on his knees, "Mr. Chairman, we have got to have an exemption to this," or "I've got to have this special allocation," and "Please do this, that, and the other for us." Doing favors is a source of power and, as I have already mentioned, inflation produces revenues that the government might not be able to get in other ways, while recession expands the market for government unemployment programs. The constituencies cultivated by government grow with economic instability.

Now, why have we had this dichotomy in our behavioral assumption? I don't know. Why don't more people notice it, or why hasn't more been said about it? Maybe Keynesian economic policy veils it because it provides the type of rationale, the type of interpretation, which does veil it. We get in frames of mind where we believe that full employment is caused by demand and inflation is caused by autonomously rising prices.

Monetarists have tried to help Keynesians understand that inflation is a monetary phenomenon, and that the monetization of the deficits that are used to expand demand is related to inflation. I don't know that they have had much success. Proponents of TIP (tax-based income policy) seem to believe that the reason output doesn't expand in proportion to demand, or money, is because business and labor take advantage of the situation to raise prices and wages. Their behavior makes the demand stimulus price-expanding rather than output-expanding. But TIP proponents, along with almost everyone else, ignore the factors which govern the responsiveness of supply to increases in demand. These factors are the relative price of leisure in terms of foregone current income, and the relative price of current consumption in terms of foregone future income -- in short, the after-tax rates of return to work effort and investment. The cheaper leisure and current consumption are in terms of foregone income, that is, the higher the marginal tax rates, the less responsive supply will be to increases in demand.

Over the last decade, the after-tax rates of return have been dropping. The decline in the responsiveness of supply to opportunities to sell is consistent with the situation in which the money supply grows faster than the rate of output.

Monetary expansion relative to output expansion is causing inflation, but other factors are causing once-and-for-all-time increases in the price level. The growth in transfers and entitlements has made it possible for people to consume output without producing it, thus increasing the demand for goods relative to the supply. If government budget deficits increase demand for output, but crowd out private

investment, their effect is to reallocate resources from investment or future production to current consumption, thereby raising the level of prices. In today's environment, small upward shifts in the price level are occurring continuously, and it may be difficult statistically to segregate these from the effect of money creation on inflation rates.

There are other things which are affecting the responsiveness of supply -- for example, federal rules and laws that reduce the value of capital assets by reducing the property rights of the owners. This has an impact on rates of return and has an impact on the amount of investment, no matter what else is going on in terms of monetary and fiscal policy. There are other things going on which may well be raising costs and causing output to fall relative to demand. A good example was pointed out by Dr. Weidenbaum when he spoke about the slowdown effect on research due to the high cost of regulations.

Rather than cite any more examples, I'd just like to say that maybe we should face the possibility that the government is not particularly interested in private sector capital formation because private sector jobs are competitive with public sector jobs. If the labor force is growing relative to the growth of private sector job opportunities, you have an expanding market for public service employment. If productivity is not increasing, the opportunities for real wage increases are not very great, and this increases the constituency for income redistribution. In other words, if you can't get ahead one way, that reduces the opportunity cost to the politicians who are offering you another way to get ahead.

I will conclude with brief remarks on some aspects of TIP. I think we have to take TIP seriously. When I heard that Congressman Mikva, who wants to reduce "tax expenditures," was interested in the carrot version of TIP, I began to wonder if Congress sees TIP in the same light as its advocates. The greatest attraction TIP has to the government is that it shifts the burden of restraining union power to private employers and removes it from the government. It thus reduces the pressure on Congress and the Executive branch to reduce the deficit, because it shifts the blame for inflation from the government to employers who don't stand up to unions. So I think that TIP will be very attractive politically. Generally the outcome of policies and ideas is different from what advocates expect, and there is no real reason why it should be different in this case.

I am not sure how TIP can reduce inflation. My interpretation is that it would raise costs and reduce investment, because it appears to reduce managerial flexibility to respond to profit opportunities. If I understand TIP, managers would be allowed to hire labor at higher wages in order to respond to profit opportunities, but they would have to pay a penalty tax for doing so. In any organization there are people who want to stand pat and people who want to move forward. It seems to me that the TIP penalty would reduce the opportunity costs of standing pat and that there would be fewer new undertakings by firms.

The main direction of my remarks, then, has been to suggest that whether economic instability is a problem or a success depends on one's point of view. Economists have not done their homework on the question

of whose interests are served by public policy. And they have neglected that the responsiveness of output is a function of after-tax rates of return.