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THE U.S. PROGRAM FOR ECONOMIC RECOVERY: ITS PROSPECTS
FOR SUCCESS AND THE IMPLICATIONS FOR LATIN AMERICA
AND THE WORLD ECONOMY

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On 18 February 1981, Ronald Reagan, President of the United States, presented his Program for Economic Recovery. The program reflects the general tenor of his election campaign, i.e. focusing on the "uncontrolled" and "excessive" expansion of government in the U.S. economy. His proposals essentially involve: (i) a reduction in government regulations on industry; (ii) a restrictive monetary policy; (iii) a 41 billion dollar reduction in the expansion^{1/} of government expenditures in fiscal 1982 (with further cuts in later years), and (iv) accelerated depreciation allowances for business, coupled with a 10% across-the-board tax cut for individuals in each of the next 3 years, all costing the government approximately \$54 billion in 1982 and \$222 billion by 1986.^{2/} I will not attempt to provide further details on the program here since a good summary can be found in the White House Summary which our Office has forwarded to Santiago, or in the February 23, 1981 IMF Survey; more ambitious readers can also consult the original document for the program which we have sent to the CEPAL Library.^{3/} The thrust of this brief note will be contained to some observations about

^{1/} The outlays will actually rise by some \$40 billion (6%) in 1982 under the Administration's plan, which is about 50% less than would be the case if no measures were taken at all. Of course in real terms there will be a fall in expenditures.

^{2/} Estimates have varied on the incidence of the reduction in taxes after full implementation of the plan, but it has been common to see figures of roughly 40% for business and 33% for individuals.

^{3/} President of the United States, America's New Beginning: A Program for Economic Recovery, February 18, 1981.

the nature of the program, its likelihood for success and its implications for the world economy, and Latin America in particular. I will attempt to be as objective as possible in the evaluation; however, the reader should nevertheless be forewarned that my natural inclination in both economics and politics is generally quite distinct from that of the Reagan camp, and this will inevitably color my perspective to some extent.

Is there a problem?

Few would deny that the U.S. has a problem. During 1970-1978, only the United Kingdom has had a lower rate of productivity growth than the U.S. within the group of major OECD countries;^{1/} in contrast, in the 60s the U.S. ranked very high in this regard. Savings as a percent of disposable income declined from nearly 8% in 1971 to only 4-1/2% in 1979; moreover the latter figure compares very poorly with savings coefficients of 20% in Japan, 13% in Germany, 17% in France, 14% in the United Kingdom, and 26% in Italy.^{2/} The growth rate in non-residential fixed investment in the U.S. has declined from an average of 7.6% per annum in the period 1960-1970 to only 3.4% in 1970-1979.^{3/} The U.S. remains one of the highest per capita consumers of energy in the world.^{4/} Also, in 1979 the U.S. rate of inflation was the tenth worst within the 24-nation OECD group.^{5/} One could go on; the point is that many long-run and short-run economic indicators confirm that Reagan is correct in

^{1/} U.S. Department of Commerce, Statistical Abstract of the U.S., 1979, Table No. 1562.

^{2/} See table on p. 120 in OECD, Economic Outlook, No. 28, December 1980.

^{3/} Calculated from data in the JEC, Economic Indicators, December 1980, and U.S. Department of Commerce, op.cit., table 715.

^{4/} U.S. Department of Commerce, op.cit., table 1564.

^{5/} OECD, op.cit., p. 47.

alerting the American public to the economic malaise of the country. In fact, most Americans already sense this, which is reflected in the strong underlying popular support for the President and his program.

The President's problem focus

Reagan's program focuses almost exclusively on reducing the role of government in the economy, with heavy emphasis on the inflationary impact of deficit financing. It would therefore be useful to examine the public sector deficit in the U.S. with that of other countries.

A perusal of table 1 would suggest that the U.S. public sector deficit in aggregate terms is not much of a problem: the deficit as a percent of GNP has been virtually nil during 1977-1979, in contrast to the relatively large deficits of other OECD countries, but especially Japan and Germany, the two success stories in this group. Is Reagan's focus on government therefore exaggerated? I would say yes and no. While the overall public sector in the U.S. is not generating a large deficit --especially in comparison with other OECD countries-- its activities could nevertheless be contributing significantly to inflation for a number of reasons.

The federal component of the public sector finance is in a fair amount of deficit, as shown in table 2. While the U.S. position does not compare badly with Germany, and is dramatically better than that of Japan, on balance its deficit may be much more inflationary. One main reason for this is that the deficits in Germany, and especially Japan, are being used to offset in part the high national savings coefficients; in the U.S. this is not the case as savings is embarrassingly low

(it dipped to a record low of only 3.5% of personal income in the fourth quarter of 1979). Another reason is that a deficit of only 2% of GNP in a trillion dollar economy is large in absolute terms and can become unwieldy when its full weight falls on a much more limited segment of the economy --i.e. capital markets; indeed crowding out and higher interest rates is a factor, especially in a time of uncertainty when risk-conscious investors are inclined towards secure investments such as those offered by government securities.

Table 1

OVERALL PUBLIC SECTOR FINANCIAL BALANCES, 1977-1980
Surplus (+) or Deficit (-) as % of GNP

	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u> [★]
U.S.	- 1.0	0	+ 0.6	- 1.0
Japan	- 3.8	- 5.5	- 5.2	- 4.5
Germany	- 2.4	- 2.7	- 3.0	- 3.3
France	- 0.8	- 1.8	- 0.8	- 0.7
United Kingdom	- 3.4	- 4.3	- 3.3	- 3.2
Italy	- 7.9	- 9.7	- 9.4	- 8.3
Canada	- 2.6	- 3.1	- 1.7	- 0.9

Source: OECD, Economic Outlook, No. 26, p. 37.

★ Estimate

Table 2

CENTRAL GOVERNMENT DEFICITS

(% of GNP)

	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>
U.S.	3.3	2.8	2.0	1.2	2.3
Germany	2.6	1.8	1.9	1.9	...
Japan	2.0	6.1	6.5	5.3	...

Source: Calculated from data in the IMF International Financial Statistics, various issues.

It also must be recognized that the Federal Government expenditures have been a steadily rising proportion of GNP: in the last few years outlays have been 21%-22% of product, which is a very significant rise over the 18%-19% figure corresponding to 1961-1962.^{1/} This rise in the profile of the central government could affect inflation in several ways. First, nearly 50% of the expenditures are for so-called entitlements, which are transfer-like payments that have their first stage impact basically on consumption. Second, another one-third of the budget is for national defense, a notoriously inflationary sector. Third, government regulations with regard to consumer affairs, health and safety, have expanded enormously in the last ten years, raising immediately the private costs of compliance, with the social gains appearing only slowly and then they are difficult to measure explicitly in any case. Finally

^{1/} IMF, International Financial Statistics, 1980 yearbook. Also note that expenditures in Germany were 15% of product in 1979, with the figure for Japan being 14%.

in an economy that still thrives on the myth of the free enterprise system, the rising share of government can have a negative psychological impact on the performance of certain economic sectors.

In sum, there appear to be a number of indications that a retrenchment of public sector expenditures may be helpful at this point in time. The increased role of government over the past 20 years has contributed to an unprecedented prosperity for Americans --something Reagan incidentally overlooks-- however, as in any process of development, formerly benign trends can eventually become counterproductive, calling forth an adjustment and shift of policy strategies. Thus it is conceivable that such a critical juncture is now presenting itself, making a slowdown in the expansion of expenditures appropriate.

The other half of the Reagan program is, of course, the reduction in taxes. The basic premise is that inflation is pushing groups into ever higher tax brackets, increasing the tax burden and eroding work incentive, investment and productivity.^{1/} The theory, promoted by economist Arthur Laffer, and non-economist Jack Kemp of the U.S. Congress, is that a strong tax reduction will pay off in an economic boom of unprecedented proportions. This idea has reached messianic proportions in the Reagan camp and is associated with the new so-called "supply" school of economics. But ironically, the theory is not new at all in as much as it has its roots in classical notions that have circulated in economic thought for more than a century: in effect, it assumes that the interest rate is a function of the supply and demand for savings; a

^{1/} In the last few years tax pressure in the U.S. has been equivalent to 19%-20% of GNP, which is exceeded by a number of OECD countries. However, in Germany and Japan it is considerably less, ranging between 12% and 13% in the former and 7%-8% in the latter. IMF, International Financial Statistics, op.cit.

reduction in taxes will increase savings, lower the interest rate and generate an investment boom, higher productivity and economic recovery. Moreover, in contrast to a traditional Keynesian approach, the supply siders appear to assume away demand constraints and revert to a type of Say's law. This is reflected in Treasury Secretary Regan's statement to Congress the other day, in which he implied that if investment should rise, it would generate the required demand.

Holding aside for the moment a critique of the supply side prescription, it seems fair to say that inflation is indeed pushing income groups into ever higher tax brackets and that this is creating unrest in the population. So again Reagan here would appear to be focusing on a real problem.

Will the program work?

Reagan's economic program has encountered a mixed reception among economists. The radical supply-siders think that the program may be a bit too timid, but certainly are in agreement on the general thrust of the measures. Some highly respected economists, such as econometrician Michael Evans, think that the program will bring unprecedented investment and growth. Meanwhile, other respected economists such as Lester Thurow of MIT caution that the program will only generate more inflation. Since I have not studied the U.S. economy in such a detailed fashion as have Evans and Thurow, it would be presumptuous of me to enter into the competition with a personal forecast of the outcome of the program. However, I would like to point out some potential roadblocks to its success.

First, concentrating on the program itself, it must confront the asymmetry between Reagan's proposals and Congress's actions. Usually it is easier to cut taxes than it is to cut expenditures, and a tax cut without budgetary restraint would be inflationary.^{1/} The radical supply-siders would argue that this is not a problem since that tax cuts would provoke increased savings and massive investment. While this could indeed happen, there is no empirical evidence to support that theory.

Tax cuts are notoriously unpredictable in their effects because of uncertainties over the short-run marginal propensity to consume that determines the outcome of tax policy: it is difficult to predict exactly what proportions of marginal disposable income will actually be saved and consumed. In this respect, there is much debate over the effects of the Reagan tax cut with erudite arguments on both sides. The supply-siders argue that since 40% of the tax cut benefits higher income groups, and another 44% the middle income groups, there will be a natural bias towards savings.^{2/} On the other hand, the supply-siders may be exaggerating the savings effects because, as some data in a recent Washington Post^{3/} editorial show, only the very high income groups can expect real gains from the tax cut; most people will be effectively standing in place in as much as the tax cut simply prevents individuals from moving into higher tax brackets on account of inflation.

^{1/} It should be noted that the mood in Congress now seems to be shifting in favor of expenditure cuts, but there is increasing resistance to the idea of tax reductions, at least as proposed by Reagan. If tax cuts should lag behind expenditure curtailment, the net effect of policy would probably be deflationary.

^{2/} The fact that the tax cut is skewed towards the upper income groups has disturbed many Democrats and explains why there is currently resistance to the tax proposal.

^{3/} The Post editorial was focusing on the equity issue rather than the

Where the program may be really vulnerable, however, is in the assumption that investment will take off due to lower interest rates.

First, with regard to the rates --Reagan predictions aside-- there is no guarantee that they will fall sharply. If tax cuts proceed at a faster pace than expenditure cuts, the federal deficit would rise, placing further pressure on interest rates. Second, commercial banks are reluctant to lower rates because they are very concerned about the slowdown in earnings growth. Third, monetary policy, which enjoys a degree of autonomy, is proclaimed by both the Administration and the Federal Reserve to be fixed in a restrictive posture, i.e., a rate of growth substantially less than rates of inflation. Fourth, and perhaps most importantly, an interest rate floor may be established on account of the strong correlation between interest rates and the fate of the dollar on foreign exchange markets.

Beyond the direction of interest rates, there is another even more fundamental question mark: it is by no means certain that investment will be stimulated by lower interest rates alone. The typical Keynesian argument would be that businessmen do not invest for its own sake (as the classical position would hold), but rather to make profits. And in the very uncertain environment of today (i.e. the direction of inflation; strength of the dollar; changes of oil prices; changes of exchange rates, renewal of cold war tensions, etc.) there appears to be poor investor confidence and a tendency to restrict commitments to the short term where profits are high and sure.^{1/} Thus, Reagan is treading on very uncertain

^{1/} As Muller has pointed out in Revitalizing America, (Simon & Shuster, 1980), corporations have increasingly branched out into non-productive activities such as acquisitions, foreign exchange and real estate speculation,

terrain when he bases his program on the reaction of investors to lower interest rates, if indeed these rates decline significantly at all.

Other considerations

The problems noted above are all secondary to one other major weakness that I can perceive in the Reagan program; that is, it has an excessively narrow focus on government that abstracts from other very serious problems in the U.S., but even more importantly in the world.

On the domestic front, Reagan apparently fails to recognize that the U.S. economy is not the homogeneous workplace it was 20 years ago, and therefore general macroeconomic fiscal and monetary policy aimed at reducing expansion of the public sector may not be an effective policy tool in and of itself. Some of the factors which can undermine the shotgun approach to fiscal and monetary policy are as follows:

- 1) It is not the entire economy that is suffering from the economic malaise, but rather a few declining industries such as automobiles, shipbuilding, steel, textiles and related industries that happen to be very large employers. Many service and high technology information-data analysis industries are doing quite well, which reflects a growing trend to a service-led economy. Thus, global fiscal and monetary policy can overstimulate some industries that do not need it and understimulate some industries that do need help;
- 2) Industries are increasingly controlled by large horizontal conglomerates that are not price takers, at least in the short run;
- 3) That decisions to save and spend are now heavily influenced by institutionalized income security in the labor market;
- 4) That inflation is being led by three sectors --housing, food and transportation. Food prices reflect the vagaries of weather and federal crop control programs; transportation costs have risen sharply because of rising oil prices, and housing reflects high mortgage rates, rising heating costs and the fact that the real estate market is pressured by corporate, and "mom and pop", type speculation, which in turn is induced by inflation and federal tax laws (which remain unchanged) beneficial to property owners. 1/

1/ See any current issue of the U.S. Bureau of Labor Statistics, CPI Detailed Report.

- 5) That the U.S. economy is still organized in such a way as to generate high per capita consumption of energy.

One could go on with examples, but the point is that Reagan's program would benefit from targetting on specific needs of specific sectors, a practice which is common in the successful economies of Japan, Germany and Austria. But in the U.S. such a strategy is associated with planning and price distortions, so that mainstream, and especially Reagan supply-side economists, would not see this as a reasonable alternative.

On the international front, Reagan's program gives no recognition to the fact that the world is an ever more interdependent^{workplace}_{1/} to read his speech one would never know that there is a world economic crisis and that many of the structural problems of the U. S. are endemic to the global system as a whole. In and of themselves, Reagan's fiscal and monetary package will not stabilize the price of world oil; will not slow the rapid international competitiveness of LDCs in basic industries; will not reduce the predatory nature of Japanese export policy, etc., all of which directly affect the U.S. economy.^{2/}

Perhaps the best example of the potential naïveté underlying the anti-big government focus of the recovery program is the proposed reduction of the loan authorization of the Eximbank.^{3/} The President argues that the reduction is because "the primary beneficiaries of taxpayer funds in this case are the exporting companies themselves --most of them profitable corporations". But the corporations that use this facility

1/ In the last 20 years, the U.S. export coefficient has doubled, from roughly 5% to its current level of 10%.

2/ When one examines the CPI in detail, it becomes obvious that rising oil prices are behind many lead inflationary sectors in the economy.

3/ See p. 3 of U.S. President, op.cit.

such as Boeing and General Electric are profitable and successful overseas to a large extent because Eximbank finance permits their products to compete with European producers which have access to cheap official-export credit facilities, e.g. Coface of France and the Eximbank of Japan. Elimination of the export subsidy program would have made sense 20 years ago when companies like Boeing and General Electric had near monopolies on their respective world markets, but not today when they must compete against the likes of Airbus Industries which has an excellent product and offers of cheap export financing. In other words, this particular proposal fails to take into account the environment within which the U.S. must now operate, i.e. its interdependence with policies of other nations.

Finally, it should be noted that this latter flaw would be fatal to a small country, but there is an outside chance that a large country like the U.S. can overcome it. President Reagan is an actor by training and he has a great ability to communicate and motivate. He has been organizing a virtual crusade on the theme of restoring the "old dynamism" and leadership of the U.S. economy, and he has stressed the lack of alternatives to his current program. Expectations are the one last factor in the equation which is the great unknown in the Reagan economic package. While important parts of the package appear to be founded more on faith than reason, if Reagan plays his "role" well, he perhaps can change expectations, which would have a positive snowballing effect in the U.S. economy, and, then, due to its size and the increasing international transmission factor, the U.S. trends would be passed onto other OECD

economies, bringing the world economy into a strong recovery. This, of course, is only a wishful scenario, but the possibility cannot be dismissed out of hand at this early stage.

Conclusions and implications for Latin America

In essence, few would disagree that the U.S. government sector needs some pruning right now. Spending and tax cuts would appear appropriate for the time if both can be done in tandem and in technically appropriate proportions. What concerns me is the lack of attention to the broader and more complex aspects of the problem in the U.S. and world economy. Not addressing these issues could be fatal. However, there is the unknown factor of expectations, which, should they be changed, would work in Reagan's favor. His administration (but especially the radical supply-siders) obviously are banking heavily on this latter factor. I wish them luck, but also hope that there are some alternative plans ready should the current program not live up to "expectations".

As far as the Latin American economy is concerned, a recovery in the U.S. would have some tangible benefits. Economic growth in the U.S. would stimulate Latin American exports and also reduce pressures in the U.S. with regard to protectionism. The current high rates of interest in the U.S. have at least two negative effects on Latin America: (i) they put a large surcharge on external debt service which makes commercial obligations more onerous, and (ii) they push up the dollar which can hurt trade performance for countries importing from dollar zones and exporting to non-dollar zones. Thus any reduction in interest rates would provide relief to Latin America. At least for these reasons the region should be

carefully monitoring the progress of the Reagan program. However, until there are concrete results, it would be prudent to maintain a healthy skepticism about the recovery scheme, and thereby continue to explore domestic, regional and international solutions to the world economic crisis.

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