

COMMUNICATIONS

THE COUNCIL OF ECONOMIC ADVISERS AFTER FORTY YEARS

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Origins, Functions, and Development

With enactment of the Employment Act of 1946, Congress charged the President to adopt economic policies that were designed "to promote maximum employment, production, and purchasing power." The Act also created the Council of Economic Advisers (CEA) "to appraise the various programs and activities of the Federal Government . . . for the purpose of determining the extent to which such programs and activities are contributing, and the extent to which they are not contributing, to the achievement of such policy and to make recommendations to the President with respect thereto. . . ." The President was directed to transmit each year an economic report that sets forth such matters as current and foreseeable trends in employment, production, and purchasing power and outlines a program for carrying out the full employment policy. Since the first report was submitted to Congress in January 1947, preparation of the annual report has been the Council's responsibility. Thus, the *Economic Report of the President, 1986*, which was submitted to Congress in February, represents the 40th-anniversary issue.

Although the Council's influence has fluctuated over the years, it has rather remarkably retained its original size and function. Initially, the three members of the Council were equal, but difficulties with this arrangement led to a reorganization in 1953 that give the Chairman superior status and made him *the economic counselor* to the President. The small professional staff has been composed of econ-

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omists on leave from their primary positions, serving the CEA for short periods of time, usually one to two years. Both the staff and the Council members have been drawn most frequently from the ranks of academic economists, although others have come from private industry, the Federal Reserve System, and other government agencies.¹

Consistent with its legislative mandate, the Council originally focused almost solely on the macroeconomic issues of unemployment and inflation. Beginning in the 1970s, as the economic policy debate shifted to microeconomic concerns, the Council too altered its focus so that today microeconomic policy occupies at least as much of the Council's time as does macroeconomic policy. This evolution has also characterized the *Economic Report of the President*. In its present format, the report includes a review of recent policy and an assessment of the near-term economic outlook, as mandated by the original legislation. The report also presents the basic short- and long-term economic assumptions on which the administration's policy proposals and budget requests are based. Unfortunately, these assumptions are regularly interpreted as the government's official macroeconomic "forecast," and the Council has been erroneously faulted when these "forecasts" prove to be inaccurate.²

From the beginning, the report has included an extensive set of statistical tables. The tables are a collation of statistical series generated by government agencies other than the CEA and provide a convenient "one-stop shop" for all kinds of economic data. Finally, in recent years, the bulk of the text has been devoted to such major economic policy issues as tax reform, trade liberalization, and welfare reform.

The active life of a report is often transitory. With the appearance of one year's report, providing a more current guide to administration policy, the previous report often becomes only a part of the historical record. There have been several notable exceptions, however. The 1962 report, for example, in the words of Hobart Rowan, "developed what might be called the 'economic conscience' of the New Frontier."³ It constituted an exposition of the Keynesian approach to macroeconomic policy and introduced such concepts as potential GNP and the full employment budget. Indeed, the full employment

¹The preceding discussion of the Council's history relies on *Economic Report of the President, 1971* (pp. 19–22), Hargrove and Morley (1984, pp. 1–44), and Norton (1973).

²I have previously discussed the significance of the distinction between the economic assumptions contained in the annual *Economic Report of the President* and the conditional macroeconomic forecasts that are prepared by private forecasting firms (McCaleb 1984).

³Quoted in Norton (1973, p. 54).

budget became widely accepted as the proper measure of the government's fiscal policy largely through the prominence accorded to it in the *Economic Report* during the 1960s and 1970s. Although originally conceived by the privately funded Council on Economic Development, the concept virtually became the intellectual property of the CEA.

More recently, the 1982 report included an assessment of the Accelerated Cost Recovery System (ACRS), the new depreciation scheme adopted by Congress in the Economic Recovery Tax Act of 1981. The Council's calculation of effective corporate tax rates by industry under the new system demonstrated the potential for inter-industry distortion that ACRS created and showed that the interaction of ACRS and the investment tax credit generated negative effective tax rates (positive investment subsidies) for some industries. This analysis has set the agenda for tax policy over the last five years, resulting in three subsequent pieces of major tax legislation.

The *Economic Report of the President* for 1985 included chapters on health care, the economic status of the elderly, and corporate mergers and acquisitions. Each of these chapters received prominent attention after publication for its balanced treatment of the issues and for its documentation of the many myths that have surrounded policy discussions in these areas. The chapter on the elderly, in particular, demonstrated that the elderly as a group are not poorer than other age groups in the population and that, contrary to conventional wisdom, old age and poverty are not synonymous.

The 1986 *Economic Report*

The 40th-anniversary report has not received the same attention as its immediate predecessor, nor is it likely to have the impact on current policy debates that some earlier reports have had. Nevertheless, the 1986 report contains several important and useful chapters and a good deal of significant information for policymakers, the general public, and professional economists alike.

The Employment Act of 1946 attempted to strike a balance between government intervention and reliance on the market, and the Council has marched "alternately under these two banners in the ensuing years" (Hargrove and Morley 1984, p. 1). The 1986 report clearly waves the free market banner, pursuing a theme that has permeated the rhetoric of the Reagan administration though not always its actions. In addition to its assessment of the overall health of the economy, this report includes chapters on economic development, protectionism and world trade, income support programs in agriculture, eco-

conomic regulation, the federal government's role in the nation's credit markets, and immigration. In each of these chapters, the report advocates greater reliance on market incentives and argues for free market solutions to economic problems.

The report takes a microeconomic supply-side view of the current economic expansion, arguing that the expansion has been led by investment spending. The Council explicitly rejects the popular notion that the expansion has been led by consumer spending so that an impending collapse of consumer spending must spell the beginning of a new recession. Similarly, the Council rejects the view that relatively high real interest rates are attributable to the federal government's budget deficit, a view which implies that, without significant deficit reduction by means of tax increases, the expansion must give way to recession. If this were true, investment would long ago have been crowded out by high interest rates. Instead, the report takes the position that high interest rates are a product of high investment demand in a disinflationary economy. Economic growth, disinflation, and the investment incentives provided in the 1981 tax law changes have so raised the internal rate of return on investment as to precipitate an investment boom that in turn has generated the expansion of the economy and high real interest rates.

Similarly, the CEA attributes the strength of the dollar and the large foreign trade deficit to strong economic growth in the United States coupled with weak growth in foreign countries. Stronger growth in the United States has raised the demand by U.S. residents for imports relative to the demand by foreigners for U.S. exports. The Council argues, however, that this factor alone would result in a trade deficit and a weak or falling dollar. Thus, the key to the strength of the dollar must be sought not in trade flows but in capital flows. The high rates of return available in the United States and the increased risk of investment in many foreign countries have made investment in the United States more attractive than foreign investment. Domestic funds that formerly went abroad are staying at home, and foreign capital is flowing into the United States. The result is a surplus in the capital account of the balance of payments, which necessarily implies a deficit in the trade balance, and a strong U.S. dollar. On this point, the 1986 *Economic Report* states (p. 50):

Capital flows, however, should not be thought of as passively financing an independently determined current account balance. Rather the desired capital account balance, determined by investors' efforts to earn the highest available risk-adjusted return, exerts an independent force on the payments balance. The current account adjusts to reflect the consequent net capital flows. This adjustment of the

current account occurs primarily through changes in exchange rates, relative prices, and income levels at home and abroad.

This is an important point that merits frequent reiteration because it is so frequently ignored. Far too much attention has been focused on the trade balance alone, as if we still lived in the world of 18th-century mercantilism.

The Council's evaluation of current economic policy follows directly from its interpretation of the recovery and expansion. Concern over the trade deficit in isolation is unfounded, and policies directed solely at reducing the trade deficit will only slow the rate of economic growth in the United States. Policies to promote faster economic growth abroad, however, will eliminate the trade imbalance without impeding the economic expansion at home. The Council finds the government's budget deficit troublesome, but not because it poses any danger of imminent recession. The Council states what others have also shown, that the cause of the current deficit is the rise of government spending, not a decline in tax revenues (McCaleb 1984). Raising taxes only confirms the previous rise in spending and will reduce the rate of growth and discourage investment. The pro-growth solution to the budget deficit problem is to reduce federal government expenditures, but the administration has made little progress toward this goal. While Congress must shoulder much of the blame, the administration itself is not without fault. Consistent with the views of its monetarist Chairman, the Council rejects short-term economic fine tuning, arguing that neither monetary nor fiscal policy is likely to secure desired results. Instead, monetary policy should be used to restore and maintain price stability over the longer term, and government policy generally should be directed at providing a stable environment within which the private economy can operate.

These policies are not only important to maintain a rapid and sustainable rate of economic growth with price stability in the United States, but in the Council's view, they would also make a substantial contribution to resolving the problems of developing countries with large and persistent international debt problems. The international debt problem is attributed to the combination of excessive reliance on external debt, lower growth rates in the industrial nations, and the collapse of commodity prices associated with disinflation. The debtor countries are in part responsible for their own plight because much of their external debt was used to finance unproductive public consumption rather than productive private investment. They failed to follow economic policies that were designed to promote growth, to minimize distortions in their economies, and to foster free, open,

and competitive markets. While the immediate crisis was precipitated by a loss of confidence of external lenders, restoration of confidence will require the adoption of policies that support sustainable growth and afford lenders, both domestic and external, a fair rate of return on their capital.

Even if the developing nations adopt such policies, their return to a high growth path will require a free and open world trading system. For this reason, the Council argues, the growing protectionist sentiment in the United States poses dangers not only for domestic economic growth but for the recovery of the developing nations as well. Unfortunately, the CEA now advocates a policy of "free and fair trade," not a true free trade policy. But, the concept of free and fair trade is simply an internal contradiction. Restraints on trade in the interests of "fairness" are nonetheless restraints on trade. Although the report attempts to rationalize administration policies that have restricted trade, the record on free trade has been less than impeccable.

As the report itself notes, restraints on trade rarely if ever lead to reduction in restraints by other countries, nor do they promote domestic employment in the aggregate, nor do they provide appropriate incentives for noncompetitive domestic industries to become more competitive. Restraints are rather more likely to result in additional restraints imposed by other countries, a lower level of employment overall, and slower economic growth. Finally, the shelter provided to protected industries by trade restraints actually removes the incentive for more competitive practices by these industries so that trade restraints adopted to provide a short-term adjustment period for noncompetitive industries merely prolong the agony of adjustment. While understandable, it is nonetheless unfortunate that the CEA has succumbed to the myth of "free and fair trade."

The discussion of agricultural policy in the 1986 report is perhaps the most useful chapter of all. It provides one of the best overviews of U.S. farm policy to date, including an excellent description of the mechanics of each of the major agricultural support programs. The Council attributes the present "crisis" in American agriculture to the expanded debt burden assumed by farmers during the inflationary 1970s, to the effect of the strong dollar on agricultural export demand, and to disinflation. Business decisions and actions that were rational in the period of high demand and high inflation are unsuited for a time of reduced export demand and significantly lower rates of inflation.

Once again, however, there is a conflict between the rhetoric of the report and administration policies. While the Council argues that the solution to the farm problem is to be sought in a return of agriculture to the competitive market, the administration has presided

over an increase to record levels in direct payments from the federal government to farmers and the expenditure of more than \$60 billion on farm programs. Meanwhile, the basic structure of the government's agricultural progress remains essentially unchanged. The result is higher prices to American consumers, which as the Council notes impose their greatest burden on poorer individuals. At the same time, inefficient resources are encouraged to remain in farming. Just as trade restraints deter rather than promote competitive adjustments in protected industries, income support programs in agriculture have become a permanent feature because they have removed the incentives for the very resource shifts that were required to allow the industry to operate competitively.

The Council suggests several alternatives to the current complex of agricultural support programs. To promote greater efficiency while still accomplishing the desired income redistribution to farmers, an alternative program must divorce income support for individual farmers from their production levels. Thus, the Council proposes direct cash grants based on income rather than production or sales, or support payments that are linked to past rather than current production levels. The administration has not, however, introduced specific detailed proposals for this kind of restructuring of agricultural policy nor does there appear to be strong congressional support.

In the area of business regulation, rhetoric and policy have for the most part met. The record of deregulation in the transportation industries is reviewed in the report, although transportation deregulation was in place when the administration took office. The Council makes a strong case for deregulation of the natural gas industry, and the administration has consistently proposed repeal of natural gas regulation to a recalcitrant Congress to no avail. Reliance on market incentives has been substituted for fiat regulation of environmental pollution with some success.

To achieve further progress toward deregulation, the Council advocates privatization, that is, contracting with the private sector to supply goods and services formerly supplied by government or even the outright sale of government assets. But, while greater economic efficiency can sometimes be achieved, the gains from privatization are easily and often overstated. The contracting process must be overseen by the same government officials who would otherwise be responsible for production, and the simple act of shifting from production by government to contracting with private producers does not alter the incentives that these officials confront. As the defense procurement system shows, contracting alone does not necessarily or obviously improve economic efficiency in the public sector.

The Council also advocates greater reliance on markets, including privatization, and on market incentives in the financial sector. In the past, government loan and loan guarantee programs could increase the possibilities for risk diversification, overcoming to some extent the inefficiencies that arose from legal impediments to interstate banking and restrictions imposed on special purpose lending institutions. The Council argues, however, that such activities can now be returned to the private sector. The diversification problem has been resolved by the emergence of alternative financial institutions. Mortgage companies provide a nationwide secondary market in home mortgages. Insurance companies could diversify risks across industries and therefore could replace the federal Farm Credit System were it not for the competitive advantage that the FCS derives from government subsidization. Finally, removal of the remaining restrictions on interstate banking and on special purpose lenders would eliminate the need for federally sponsored credit programs to promote more efficient risk diversification. The major effect of these credit programs now is simply the provision of subsidies.

Although recognizing that the system of deposit insurance needs to be restructured, the Council does not advocate greater reliance on the market in this area. Instead, it proposes structural reforms so that the system no longer provides incentives to bank managers to undertake excessive risks. Whereas the present system imposes the cost of bad decisions on other financial institutions and potentially on the taxpayers, these costs should fall on managers and shareholders. The Council notes, however, that "None of the devices for controlling adverse incentives introduced by deposit insurance is perfect" (p. 203).

In its concluding chapter, the 1986 report examines the immigration of workers into the United States. Applying the economic logic of free trade, the Council argues that on balance immigration promotes greater efficiency and a higher rate of economic growth. Indeed, one obvious response to barriers to the international movement of goods and services is movement of the labor and capital that produce those goods and services. Thus, the arrival of immigrant workers makes viable domestic production of goods and services that would otherwise be produced abroad. New workers also expand the labor force, directly increasing the economy's potential output, and the larger labor force increases the productivity of other inputs such as capital and complementary workers. Finally, the new immigrants represent additional demand for goods and services. The arrival of immigrant workers does of course alter the distribution of income, and the adverse distributional effects are concentrated on native-born workers who compete with immigrants for jobs. Nevertheless,

the positive effects of immigration on aggregate income, employment, production, and growth, although dispersed throughout the economy, exceed the adverse (and likely short-term) effects on displaced workers.

Overall, the *Economic Report of the President, 1986* compares favorably with previous reports and reflects well on the Council of Economic Advisers on the 40th anniversary of its creation. The report provides a well-written, well-documented microeconomic supply-side interpretation of the course of the economy over the past six years. Its analysis of the major issues in economic development, international trade and immigration, agriculture, and regulation from a free market perspective is a useful contribution to the current policy debates. Nevertheless, in many of these areas, we must still await the translation of advocacy into action.

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