POLICY REPORT

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How to Really Cut the Budget

by David Boaz

The battle rages in Washington: Are President Reagan's budget cuts too drastic? The *Washington Post* summed up the mood in a baleful headline: "Epic Political Struggle Looms/Official Washington Realizing Reform Crusade Is Not Business-as-Usual."

Rarely does anyone in the media stop to explain just how large—or small—Reagan's budget cuts are in proportion to the budget itself. The cuts are described as "massive" or "sweeping," and certainly the figure of about $48 billion is impressive. But the federal budget was projected to be about $740 billion in 1982; $48 billion is about 6% of that budget, and the projected Reagan budget of $695 billion would still be some $32 billion higher than the 1981 Carter budget.

In fact, Reagan's cuts are not drastic at all. They are a drop in the bucket—an important first step, but still only a first step.

The federal budget is out of control. The projected 1982 budget of $740 billion is more than double the 1976 budget, and $561 billion higher than the 1968 budget.

In 1976 Ronald Reagan ran for president and called for a $90 billion cut in the $374 billion federal budget. Even adjusted for inflation, that 1976 budget would now be under $600 billion—and a 25% cut would bring it down to $450 billion. Yet President Reagan is proposing to cut the budget not to $450 billion or to $600 billion but to $700 billion. If Reagan was correct in 1976 in saying that the budget was too high, then why isn't he proposing to cut it back at least to that level?

Even a sharp-eyed budget analyst like David Stockman cannot find the real waste in the federal government. No request for additional personnel mentions that present employees may do crossword puzzles all morning; the request simply states that the agency has a backlog of paperwork. Unless he makes personal, unannounced visits to every single federal office, how is Stockman to know the extent of governmental featherbedding? A thorough review of the federal budget, however, can suggest a lengthy list of additional cuts in specific programs.

"If Reagan was correct in 1976 in saying that the budget was too high, then why isn't he proposing to cut it back at least to that level?"

(Admiral Hyman Rickover once stated that the best way to reduce the size of government was to block off half the parking spaces in each agency one morning. Those employees who failed to get a space would be dismissed. This paper will not propose that method of budget cutting, but it seems entirely possible that a similar approach may be the only way to eliminate waste.)

A mere reading of the budget identifies some programs as waste. The General Services Administration reported recently that it was unable to determine the purpose of nearly three million trips taken by government employees during 1979. The members of the FDR Memorial Commission have spent 25 years trying to decide on a suitable memorial to a president who said the only memorial he wanted was a clump of rosebushes. Seventeen years after the last American smallpox case, the Office of Smallpox Eradication still spends more than $1 million a year. The American Battle Monuments Commission, the Japan–U.S. Friendship Committee, the National Commission on Libraries and Information Science—agencies like these waste millions or perhaps billions of dollars a year.

Any serious budget-cutting plan will require that some significant programs be eliminated, which will mean that some special interests will be offended. Abolition of the Department of Energy, a sometime Reagan promise, would incur the wrath of major oil companies receiving DOE subsidies, inefficient refiners benefiting from the entitlements program, and ideological groups bent on perpetuating government regulation. But the great bulk of the American people, both as taxpayers and as energy consumers, would benefit—and it is they that Reagan was elected to serve.

It should be pointed out that the primary purpose of cutting or eliminating a federal program is rarely to save its cost in tax dollars. A great many federal programs do positive harm. Even if their cost in tax dollars were zero, we would be better off without subsidies to business, unnecessary and oppressive regulation, and programs that distort the economy or interfere with individual rights.

Following is a detailed list of another $72 billion in cuts on top of what David Stockman has already proposed. With a few exceptions, the budget figure listed is from the 1981 budget, so the cuts from the 1982 budget would be even bigger.

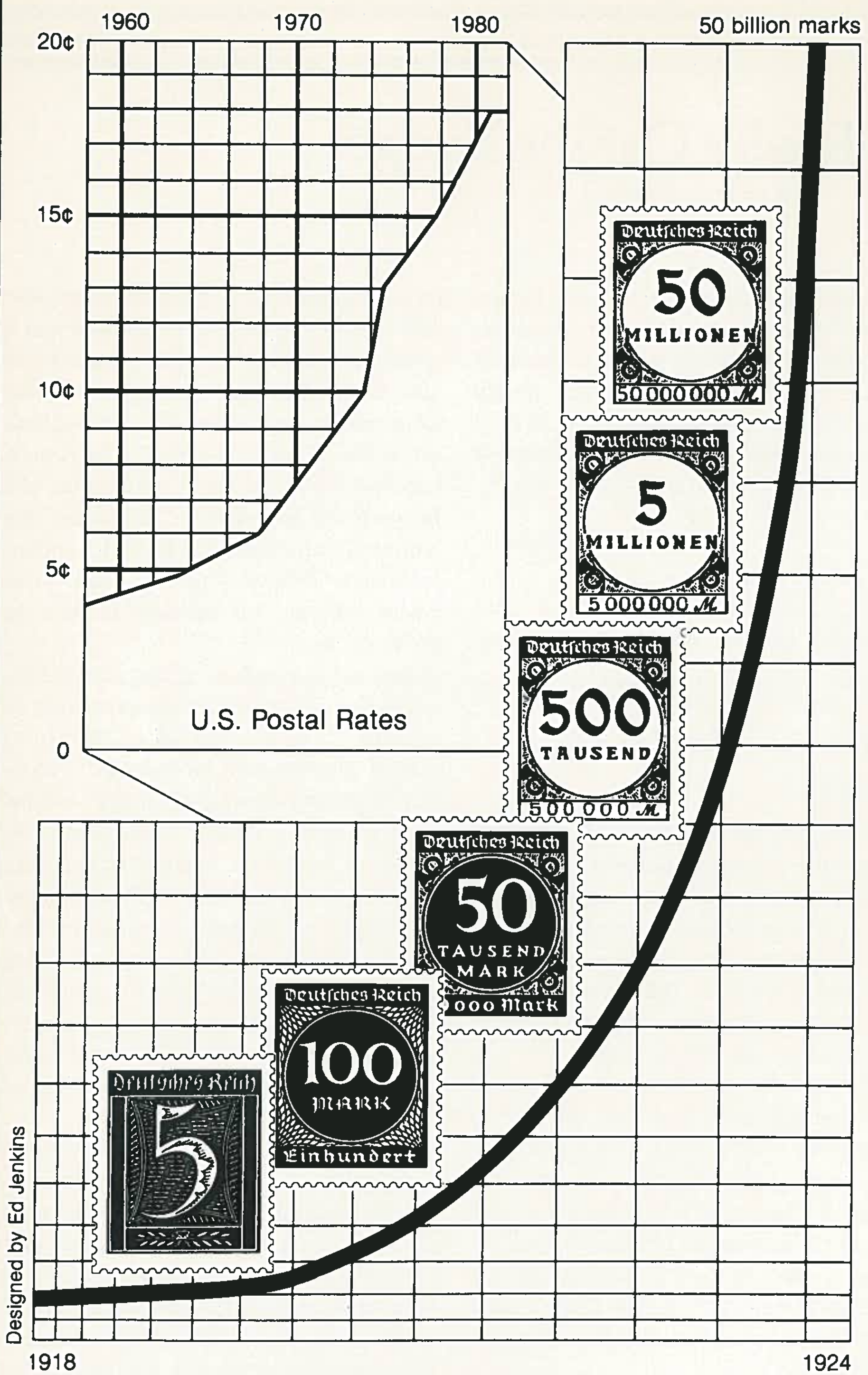
(Cont. on p. 3)

David Boaz is executive editor of *PR* and the author of several studies of the budget and spending reduction.

EDITORIAL

Inflation and Postal Rates

by Howard Bloch



Post-WWI Inflation in Germany as Reflected in Postal Rates

Postal rates have already risen by 20% this year and are very likely to rise by another 11% before next January. The price of sending a letter mirrors the general inflation that besets our economy, and if the trend continues our postal history may parallel that of post-World War I Germany. The statistics of that period make awesome reading. In August of 1922 Germany's money supply stood at 252 billion marks. By January of 1923 it had risen to 2 trillion, in September it reached 28 quadrillion, and in November it reached 497 quintillion (497 followed by 18 zeros). In January of 1922 the country's wholesale price index was at a level 4,626 times the 1913 average. By December of 1922 the index was approximately 400 billion times the 1913 average and had become essentially meaningless. In the latter months of 1923 the decline in the mark's value was so rapid that it was necessary for paychecks and bills to be collected at least daily (often twice or more during a day) and spent at once, since if the cash were held until the next day it would lose much of its value.

As a result of the inflation, postal rates reached insane levels. First-class postage that had cost a few pfennigs soon cost a few marks, then a few hundred marks, etc. By 1923 stamps were being printed in denominations of hundreds of thousands of marks. The cost of mailing a letter quickly rose to millions then to billions of marks. The largest denomination stamp, printed in the latter part of 1923, had a face value of 50 billion marks. However, by this time, because of the inability of the post office to keep up with rapidly rising rates, stamps were being sold for and accepted for four times their face value, and thus the stamp had an actual value of 200 billion marks. The lessons of this Alice-in-Wonderland period should be clear to politicians and governments all over the world; unfortunately they seem to have to be relearned several times every generation. ■

Howard Bloch is a professor of economics at George Mason University.

The Budget (Cont. from p. 1)

Budget area	Savings (millions of dollars)
Useless or wasteful programs	475.360

This category includes the Office of Technology Assessment, the Minority Business Development Agency, the U.S.-Yugoslavia Bilateral Science and Technology Agreement, the Civil Defense Preparedness Agency, the National Scenic and Recreation Highway, bicycle path programs, Regional Development Programs, the Law Enforcement Assistance Administration, and many others. These agencies serve no useful purpose. They were started as a favor to a member of Congress or to a special interest group, and they spend taxpayers' dollars with no discernible effect.

Legislative and executive branch savings 347.972

The budgets of the legislative and executive branches have soared in recent years and now amount to some $1.4 billion. Former Rep. Stockman, now a member of the executive branch, should set an example by cutting his own and his colleagues' budgets.

Subsidies to business and agriculture 16,258.447

This figure hardly represents all the business subsidies found in the budget, but it does include such major programs as the Department of Agriculture's Foreign Assistance Programs, Commodity Credit Corporation, and Milk Market Assessment Order; the Maritime Administration; HUD's construction subsidies and community development programs; and the Export-Import Bank. It is no accident that so much of the budget is devoted to business subsidies—businesses set up Washington lobbies for a reason, after all. These programs offer grants, loans, loan guarantees, interest subsidies, price supports, and other assistance to businesses. But taxpayers shouldn't have to subsidize businesses. The Reagan administration should abolish these programs and let businesses sink or swim in the market.

Medicare and SSI 5,300.

Medicare and Supplemental Security Income were among the programs exempted from Stockman's cuts. Surely he could find room for a 10% cut in two programs that together have soared 60% since 1977.

Energy programs 10,176.156

President Reagan has ended the price controls on oil, but he has not yet eliminated DOE subsidies to energy producers. Indeed, he has *increased* subsidies to nuclear power. Energy alternatives should compete in a free market, or we will simply create another energy crisis by letting government set our course.

Railroad subsidies 1,403.49

Stockman proposed cutting the Amtrak subsidy, but he didn't explain why taxpayers should subsidize train travel at all. The Reagan administration should deregulate and denationalize the railroad industry rather than keeping it on a federal life-support system. Then, if consumers want train travel, they will pay for it.

Corps of Engineers 448.519

America has suffered from the corps's philosophy of "if it flows, dam it" long enough. The corps has built water projects as political favors to powerful members of Congress and as public works projects. Individual rights, private property, and environmental concerns are overridden with little thought. The Coalition for Water Project Review has cited ten corps projects that could be reduced in funding with little damage.

(Cont. on p. 4)

In This Issue

How to Really Cut the Budget 1
Inflation and Postal Rates (Editorial) 2
The Monetary Crisis: Why Quantity Rules Are No Solution 5
Regulatory Watch/The Freeze 7
Washington Update 8
Briefs 9
Inflation Monitor 10
PR Reviews 11
"To be governed . . ." 12

POLICY REPORT

Published by the Cato Institute, *Policy Report* is a monthly review that provides in-depth evaluations of public policies and discusses appropriate solutions to current economic problems.

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The Budget (Cont. from p. 3)

Budget area — **Savings (millions of dollars)**

Department of Education — 11,479.218

The Department of Education tends to centralize education in the United States, discouraging the natural diversity that might otherwise occur. Federal funding and control of education should be ended. And abolition of the department must not mean simply sending the various agencies back to the departments from which they came. It should mean an end to federal involvement in education.

International Development Assistance — 1,950.914

These intergovernmental lending and assistance programs tax U.S. citizens in order to prop up governments in Third World countries. Little if any of the benefit is ever received by the people of these countries. The beneficiaries are the governments in other countries and the American businesses from whom purchases are made with the funds received. Stopping this boondoggle would help both the taxpayers of the United States and the people of the Third World.

Mobile Home Inspection and Monitoring — 7.

This program has been highly popular with the mobile home industry, which it purports to regulate. Like most economic regulation, its effect has been to limit entry, restrict competition, and drive low cost–lost price competitors out of business. It protects the industry, not consumers.

National Consumer Cooperative Bank — 161.06

This bank will contribute to further government control of the capital market, provide government-subsidized competition for new banks, and engage in inflationary creation of new credit. It should be stopped in its tracks.

Revenue Sharing — 7,862.444

The very title of this program is absurd. There is no (net) federal revenue to share.

EPA Construction Grants — 1,550.

Stockman proposed to limit EPA funding of waste-treatment plants, but he didn't go far enough. This is in effect a form of revenue sharing, and once again there is no revenue to share.

Employment and Training Administration — 6,309.662

Stockman proposed cuts in the CETA program. He should finish off the job. CETA is a boondoggle riddled with mismanagement and politicization.

Occupational Safety and Health Administration — 208.02

OSHA has had no effect on worker health and safety. Indeed, some experts argue that it actually decreases safety because workers and unions no longer take responsibility for safety problems. OSHA also involves serious civil-liberties problems.

Community Services Administration — 560.

CSA is a subsidy program for social workers. It has no long-term positive effects for the poor. Reagan should abolish it and implement innovative ideas like education tax credits and enterprise zones to allow the poor to solve their own problems.

Civil Aeronautics Board — 115.717

After deregulation, who needs it?

Interstate Commerce Commission — 83.773

The ICC has almost driven the railroads out of business, while it protects truckers from competition. It keeps potential competitors locked out and consumer prices high. Of course, truckers and Teamsters expect the proper gratitude for their support of Reagan, but there is no excuse for keeping the ICC around.

If the Reagan administration really wants to cut the budget, it should be able to find plenty of opportunities in this list—or in other areas. The foregoing is certainly not to be considered a complete list of possible budget cuts.

In the weeks since the Reagan budget proposals were announced, every network news program and every major newspaper has offered us daily stories of the people who will be hurt—the not-quite-needy food stamp recipients, the businesses subsidized by the Ex-Im Bank, the local school districts, and so on. No one has presented interviews with the people who will gain from reduced levels of taxing and spending. Is this an example of media bias? Partly, perhaps, though it may be a bias toward a heart-rending story rather than toward any particular political viewpoint. But more than bias is involved here. It is nearly impossible to identify specific beneficiaries of a lower tax level. Of course, each American will get a slightly lower tax bill than he would have otherwise, but few middle-class families are going to change their lifestyles in response to a $200 tax cut.

No, the real problem is more subtle. It's the one identified by Frédéric Bastiat in his essay "What Is Seen and What Is Not Seen," and by Henry Hazlitt in his marvelous book *Economics in One Lesson:* It is always easy to know who benefits from a government grant of money. The losers from such a policy of taxing and spending are harder to find. They are the entrepreneurs who couldn't afford to start or maintain a business, the workers who didn't get jobs in that business, the consumers who weren't able to buy a better product at a cheaper price. But it is almost impossible to identify the specific business that failed or was never started because of a particular level of taxation.

Thus there is no opportunity to interview a person who will benefit from reduced levels of taxation. Which entrepreneur knows that he will be able to borrow money next year solely because of tax reductions? Which worker knows that his wages will be bid up because of the increased money available in the private

Corporation for Public Broadcasting and the National Foundation on the Arts and Humanities — 361.592

The case for abolishing these agencies is actually *stronger* than the case for reducing their budgets. Federal involvement in broadcasting and the arts is a threat to the First Amendment; why is "public" broadcasting any more acceptable than a federally established "public" newspaper? In addition, these programs are elitist. The average taxpayer should not have to subsidize the cultural activities of the affluent.

Federal employee retirement — 1,300.

Although most taxpayers are forced to participate in the Social Security system, which pays them much less than a private system would, federal employees are exempt. They participate in a separate system, where the benefits-to-payments ratio is better—like the difference between Chivas Regal and Ripple. Federal employees contribute about 25% of the retirement fund; taxpayers make up the rest. The cost is soaring. A first step in getting it under control would be to freeze the taxpayers' contribution at its 1980 level. If federal employees feel that that will jeopardize their retirement system, they will be free to increase their own payments.

Selective Service System — 27.13

For 17 years Reagan has been an outspoken opponent of the draft and draft registration. At last he has the opportunity to make good on his promises.

Modified COLA for federal retirees — 803.

Federal retirees get twice-a-year cost-of-living adjustments. Changing this to once a year would save taxpayers $803 million this year and much more in future years.

Civilian employees wage freeze — 4,500.

Federal employees earn about 40% more on the average than the private-sector workers who pay their salaries. Until that disparity is made up, they should not get any wage increases.

TOTAL ADDITIONAL BUDGET CUTS — 71,689.474

sector? Which consumer knows that new products will be available next year because the burden of taxation has been reduced?

As we read the stories about those who will be hurt by Reagan's budget cuts, we must remember that reductions in the rate of taxing and spending will benefit everyone in society except those few special interests who profit at other people's expense. The poor will be helped far more by a growing economy than by welfare programs.

Unfortunately, President Reagan hasn't cut the budget yet. He is still proposing budget increases of some $32 billion in 1982, $37 billion in 1983, and $38 billion in 1984. He is not freeing the American economy, and we cannot expect major economic growth from his program. But it should be clear that the budget *can* be cut, if only the political will to do it is present.

The April 1981 *PR* neglected to note that Joe Cobb, the author of "Politics and the Decontrol of Oil," is Director of Economic Analysis for the Council for a Competitive Economy.

The Monetary Crisis: Why Quantity Rules Are No Solution

by Marc A. Miles

As inflation continues with no end in sight, the question of monetary policy is moving to the forefront of public policy debate. In this issue PR *offers the first of three perspectives on inflation and monetary policy. Professor Miles's article approaches the question from a global monetarist viewpoint. Future articles will offer contrasting views, proposing the gold standard or a competitive currency system as alternatives to our present monetary arrangements.*

Marc A. Miles is an associate professor of economics at Rutgers University.

Few would disagree that double-digit inflation is becoming a way of life in the United States. Precisely how to deal with the surging inflation, however, has become the source of tremendous disagreements. One suggestion receiving considerable attention in the last couple of years is the "quantity rule": The Federal Reserve restricts the rate of growth of the money supply to some constant rate. The Fed decides what rate of money growth is consistent with low inflation and uses its powers to ensure that the money supply grows at the targeted rate. Successful adoption of this quantity rule, it is reasoned, will reduce inflationary expectations.

The logic of the quantity rule, however, has a number of problems. Even from a purely domestic perspective the rule is unworkable. In the first place, the growth of money substitutes makes it unlikely that the Fed is even targeting the relevant supply of money. M1-B, for instance, does not include money-market funds, repurchase agreements, or unutilized trade credit, all of which can potentially be used as money. The published money supply figures may therefore not be meaningful.

Second, even if the figures were meaningful, it is questionable whether actions taken by the Fed control their level. Studies have shown that changes in the private sector's holdings of currency relative to deposits, or the composition between demand and time deposits, can offset the Fed's attempts to restrict or expand the money supply.

Third, even if the Fed could control the relevant money supply, the quantity rule by itself is incomplete. Inflation, after all, is caused by an excess of money supply over money demand. If one wants to stabilize prices, one must stabilize money supply relative to money demand, not simply the rate at which the money supply is growing. Successfully stabilizing prices by manipulating the money supply therefore requires precise, accurate forecasts of changes in money demand, something economists have not yet mastered.

Yet even if these domestic problems could be overcome, the international or global money markets confront the Fed with additional forces that strongly undermine the efficacy of a quantity rule. For example, new avenues for circumventing the Fed's actions, such as the Eurodollar market, now appear. But perhaps even more importantly, with global money markets the range of choice of money assets available to an individual to satisfy his demand for money greatly expands. The individual can now hold his money in a variety of assets in a variety of currencies. As we shall see, the profound effect of this additional freedom of choice is that the monetarists' fundamental dream of a U.S. monetary policy independent of all other countries becomes an impossibility.

Freedom to Choose in Global Markets

Imagine a treasurer of a large international corporation who decides to invest the corporation's entire bond portfolio in dollar-denominated bonds. Such a person certainly has access to international bond markets, and he probably is also receiving a steady stream of information on the outlook for the dollar compared with other currencies. Yet despite dismal projections for the dollar's value and increased uncertainty about the dollar's future, that treasurer rigidly clings to his all-dollar portfolio.

This example is merely intended to emphasize some of the inconsistencies between the conventional assumptions about the international bond and equity markets on the one hand and the international money market on the other.

> **"The existence of international or global money markets confronts the Fed with additional forces that strongly attack the credibility of a 'quantity rule.' "**

The widely held view of the demand for bonds and equities is that investors are free to diversify their holdings of these assets in order to reduce the overall risk of their portfolios. One source of risk is uncertainty of exchange-rate depreciation, which can potentially inflict capital losses on assets denominated in a given currency. Faced with exchange rate uncertainty, the rational investor will diversify the currency denomination of his asset holdings, thereby reducing the risk of capital loss.

However, according to monetarists who espouse the quantity rule, the holder of money balances is not expected to act in such a rational fashion. The conventional assumption about money demand is that like the mythical corporate treasurer, individuals or firms in a particular country demand the money of that country only, regardless of the cost or risk. In other words, regardless of the recklessness of Federal Reserve policy, Americans are assumed to hold only American dollars. The same behavior is assumed to exist among the Germans, the Japanese, and the Italians.

Such asymmetry of responses in the two financial markets is illogical both theoretically and empirically. Theoretically there is no reason why individuals and firms should not diversify their money portfolios as well as their bond and equity portfolios. Depreciation also inflicts a capital loss on domestic money balances by reducing purchasing power on world markets. If an investor holds monies of several different currency denominations, the capital loss on some balances can be offset by the gain in other denominations.

Empirically the tremendous increase in the fluctuations of currencies in the last few years has provided an incentive for such diversification of money balances. Furthermore, the expansion of trade between countries, the growth of the Eurocurrency markets, and the increased incidence of corporations with offices in several countries all present abundant opportunities for discretionary choice of the currency of transaction. Taken together, these theoretical and empirical observations imply that an individual or firm should not maintain all of its money balances in its own national currency, but should observe diversification among monies of different denominations, or "currency substitution."

With diversification, a country's money becomes internationalized as it finds its way into the money balances of foreigners as well as domestic residents. Money demand within a country now includes foreign as well as domestic money, the relative composition depending on the usual portfolio-determining variables, the expected return and risk of return of the various monies. As a result, the basic analysis of money demand, prices, interest rates, and exchange rates must now be expanded to an international portfolio framework.

Evidence of an International Portfolio Demand for Money

Economists are beginning to uncover evidence that the incentives for diversification exist and that money portfolios respond to them. For example, in the November 1978 issue of the *Journal of Money, Credit and Banking*, Haim Levy and Marshall Sarnat calculate how the average rates of return and standard deviations of foreign currencies differed during periods of fixed exchange rates when compared

with the recent period of floating exchange rates. They conclude that during the fixed-rate period the changes in the exchange rate were not sufficiently large to create an incentive for money portfolio diversification. With the breakdown of the Bretton Woods system, however, the average rates of return and standard deviations (a measure of variability) rose dramatically, providing a strong incentive for money diversification.

In other words, during fixed-rate periods the central banks of various countries make all currencies perfect substitutes on the supply or central bank intervention side. The holder of a dollar or a deutsche mark simultaneously holds an equivalent amount of all other currencies. There is little, if any, difference between expected returns or risks of return on individual currencies. But when central banks eliminate this guarantee during floating-rate periods, the private market has the incentive to deal with the new uncertainties by diversifying or substituting among monies through money demand.

My own research on the United States, Canada, and Germany has shown not only that the advent of floating rates creates an incentive for money diversification, but that the incentive to diversify is sizable enough to induce significant responses in the private sector. In all three countries the measured degree of responsiveness of relative money holdings to changes in relative expected returns was insignificant during fixed-rate periods and very significant during periods of floating exchange rates. This evidence represents a rejection of the traditional monetarist argument.

Evidence also exists of the money substitution phenomenon in response to changes in relative risk. For instance, one might expect the currency in which a Eurocurrency market loan or deposit is denominated or international trade is consummated to depend on the risk of contracting in the different currencies. For example, a German company and its customers in South America may initially denominate their transactions in dollars. The dollar in its role as an international reserve currency is readily accepted in most countries and is the most convenient form in which the German company can denominate these international transactions. If the risk or uncertainty of holding dollars increases, however, the company and its customers may decide to denominate their transactions in more stable currencies. Even if the expected return on the dollar does not change, an increase in the uncertainty or variance of return increases chances that either seller or purchaser will experience a capital loss.

Similarly, when dollar risk increases both borrowers and lenders in the Eurocurrency markets now find contracting in dollars more risky. Hence, both groups should now be expected to desire more of their agreements to be denominated in other, relatively more stable, currencies. In other words, the risk of a currency becomes an important issue in exposure management, affecting both the asset and liability sides. The proportion of both Eu-

(Cont. on p. 9)

Regulatory Watch

THE FREEZE

Although President Reagan has ordered a temporary freeze on new federal regulations, the *Federal Register*, the government's "magazine" of public regulations and legal notices, is still being published every day by the General Services Administration. The average daily length of the *Federal Register* continues to be nearly 300 pages despite the freeze. Most of these pages are filled with notices, proposed rules, rulings on specific cases, and announcements of meetings.

On 24 February 1981 the Pension Benefit Guaranty Corporation issued an entire series of rules amending some of its previous regulations, which were published last January. The purpose of these amendments is to delay the implementation of these rules until 1 April 1981 so that they may escape President Reagan's freeze. Among the measures saved were regulations on employee and multi-employee pension plans, the allocation of assets therein, and the valuation of plan benefits.

The Small Business Administration has proposed a cessation of loans to the drug paraphernalia business (headshops). Although the SBA had previously permitted such loans, the new ruling would cut off assistance to any borrower that "produces, services, or distributes any product or service used in an illegal activity." Officials have cited the unsound financial nature of the paraphernalia business as a reason for the ruling; many states are currently in the process of outlawing the industry.

The Federal Emergency Management Agency, a branch of the Federal Insurance Administration, has drawn up a list of communities that are no longer eligible for federally subsidized flood insurance, effective 1 March 1981. These communities have lost their eligibility because of failure to enact adequate flood plain management procedures. Because such an action is not a *new* regulation, but rather an application of old regulations, it does not fall under Reagan's prohibition.

The Veterans Administration has amended the Adoption Assistance and Child Welfare Act of 1980 so that veterans may choose to continue receiving their pension as they did in December 1978, rather than receive the higher pension currently due to them. Much of the issued amendments discuss the different choices in pensions available to veterans and widows of veterans of the Spanish-American War.

New regulations proposed by the Commodity Futures Trading Commission would prohibit a futures commission merchant from guaranteeing his clients against loss or guaranteeing to limit the loss on investment. These practices are known in the profession as "limited risk" agreements. The CFTC cited fraud and unlawful conduct on the part of the merchants participating in these agreements as reason for the regulation.

Washington Update

The American banking community has recently petitioned the Depository Institutions Deregulation Committee (DIDC) for ceiling rate adjustments on the rates of interest that banks are allowed to pay. DIDC approval of such a measure would allow banks to introduce two new deposit instruments designed to compete with money market funds. The first instrument is a certificate having a 30-to-60-day maturity combining higher yields than current passbook rates and greater liquidity than six-month money market certificates. The other potential new instrument, the so-called wild-card certificate, would allow banks to offer certificates at any interest rate for up to 5% of their assets.

The Reagan administration has recently moved to review the need for Federal Housing Administration mortgage insurance. Budget Director David Stockman pointed out to a House banking subcommittee both that the private mortgage insurance insures more home mortgages at a lower price than the FHA and that the average income of the families helped by the largest FHA program was nearly $30,000. Stockman hopes to abolish FHA mortgage insurance altogether.

Rep. Howard Wolpe (D-Mich.) is preparing legislation that would cripple the Federal Trade Commission's antitrust suit against ready-to-eat cereal manufacturers. The bill, which would place a moratorium on the preparation of initial decisions in shared-monopoly cases, already has the support of at least 20 House members. Sponsors of the legislation are hoping for the support of President Reagan in light of his previous strong criticism of the FTC actions.

President Reagan has withdrawn nearly all of the Carter administration's interim and proposed rules for a standby gas-rationing plan. Among the measures scrapped are the shortened workweek, limitations on vehicle use, an odd-even system for gasoline purchases, office temperature restrictions, and a lower speed limit. The only two emergency conservation measures retained were the DOE's public relations program and the minimum requirement for gasoline purchases.

Secretary of Education Terrell H. Bell has cut back the number of high-level jobs in his department on the grounds that it had "too many chiefs for our small size." Bell eliminated 4 of the department's 13 assistant secretaries as well as several of the special assistants attached to these posts. Most of these jobs paid more than $50,000 a year.

The Reagan administration has backed off from its attempt to eliminate the antitrust authority of the Federal Trade Commission, but instead has asked the agency to make across-the-board cuts in spending. The OMB's proposed cuts for the FTC would reduce its fiscal 1981 budget from $77.9 million to $67.7 million, followed by a fiscal 1982 budget of $59.4 million. By 1985 the FTC budget would be reduced to $41 million.

The National Commission on Social Security, a Democratic party–controlled, congressionally appointed study committee, has formally recommended that the nation's social security system be salvaged by the use of income tax revenues to finance payments. The panel also recommended gradually raising the retirement age from 65 to 68 by the year 2000, a 2.5% income tax surcharge to ensure the Treasury's ability to finance other welfare programs, and a downward recalculation of social security adjustments for inflation.

A group of congressional liberals has recently reintroduced the "open housing" bill that died in the Senate last year. The bill would add enforcement teeth to a 1968 act that outlaws racial discrimination in the sale or rental of housing. This act is now enforced by the federal courts, but this bill would shift the enforcement powers to an independent administrative agency.

Several major oil refiners that have been accused of pricing violations by the Department of Energy have settled the charges by agreeing to pay $157 million in refunds and price rollbacks and to forgo future price increases of $1.66 billion. Most of the payments will go to states, utilities, and airlines.

Among the first budget cuts approved by the 97th Congress were slashes in funding for Senate committees. The Senate voted 93 to 0 to provide its committees with $41.7 million for the year beginning March 1, compared to $46.3 million the committees had last year.

The Congressional Budget Office has projected that next year's budget deficit will be $67 billion, $22 billion more than the Reagan administration estimated. It was also predicted that the federal government will fall $49 billion short of a balanced budget in 1984, the year that Reagan expects the budget to be balanced. The CBO attributed its different figures to its different assumptions about the effects of Reagan's economic programs on the economy.

Labor Department officials have announced that the Reagan administration will seek an extension for a CETA job program that employs some 52,000 elderly Americans in libraries, hospitals, and construction projects. Next year 1,000 positions will be added to this project, pushing its total cost to $277 million.

Treasury officials have recently testified before Congress that legal gambling should be exempt from federal taxes. Current federal law places a 2% tax on sporting event wagers and private lotteries such as numbers games, which must be borne by the person accepting the wager. There is an additional occupational tax of $500 a year simply to take wagers professionally.

Although President Reagan still favors the idea of a subminimum wage for youth, he is not yet prepared to endorse any of the three bills before Congress. The first bill would eliminate the minimum wage altogether for workers under 18, while the other bills would cut the minimum by either 20% or 15%. All of these bills are scheduled for debate in the current session of Congress. ■

The Monetary Crisis (Cont. from p. 7)

rocurrency assets and liabilities denominated in currencies other than dollars would be expected to rise.

Some Implications of Diversified Money Holdings

Given the apparent evidence of diversified money portfolios and that the composition of the portfolios adjusts to changes in the cost or risk of holding the different currencies, what are some of the implications for government policy and financial decisions? One important implication is that traditional concepts of the sources of supply and demand in domestic money markets must be reexamined. For example, conventional monetarists who recognized under the fixed-rate system that the U.S. money market was highly integrated into the world money market welcomed the current floating rate regime as an opportunity to separate the U.S. and world markets. The separation of money markets in turn was to provide U.S. policymakers additional powers to control the economy. The basis of this belief, however, was that Americans hold only their domestic money. Hence, if the Federal Reserve increases the supply of dollars, these dollars must ultimately be returned to the United States since no one elsewhere in the world will hold them. All effects of U.S. monetary policy are therefore felt within the country, and since money demand is determinable, the Federal Reserve can concentrate on the money supply and apply the quantity rule.

However, if under floating rates individuals and firms around the world hold diversified money portfolios, then dollars are held abroad as well as in the United States. Increases in the dollar money supply by the Federal Reserve may therefore not all remain here but instead may become dispersed throughout the world as private-market money portfolios respond to changing market forces.

But even if some monetary authorities could control the quantity of domestic money within their borders, such an ability to regulate is no longer a sufficient condition to produce an independent monetary policy. With the private sector holding diversified money portfolios, domestic money is only part of the relevant money supply. The remaining portion, foreign-currency-denominated money, is beyond the control of the domestic monetary authorities. Flows of money now occur between countries through the private market, and the usefulness of monetary policy for tuning the economy is again reduced.

A simple analogy helps. Suppose the Federal Reserve Bank of Atlanta decides to use a quantity rule that is independent of policies in other districts. The Atlanta Fed, after all, issues money with a distinctive district seal. But that same Atlanta Fed dollar is a close substitute in money portfolios for dollars from the other eleven Fed districts. If the Atlanta Fed wishes to use the quantity rule to reduce inflation in its

Briefs

□The Internal Revenue Service has decided to crack down on the auto workers' tax revolt in Flint, Michigan, (see April *Briefs*) by drawing up new rules that force an employer to withhold income tax according to the number of dependents of an employee that the IRS approves. Many of these workers had been claiming 99 dependents, assuring that no federal income taxes would be withheld. The IRS has stipulated these rules to be temporary in order to sidestep the 60-day waiting period (for public comment) that accompanies permanent regulations.

□Although David Stockman had testified before Congress of a freeze on pending grants from the Economic Development Association (EDA), President Reagan announced two EDA grants of more than $5 million to New York City during his recent visit to the Big Apple. Only two days later the EDA announced the unfreezing of 60 EDA grants and loans for projects totaling over $70 million.

□Civil service union leaders in Britain have ordered 2,300 employees to shut down the government's income tax computers as a protest against low wages and high taxes. In addition, 260 workers in London are refusing to collect nearly $770 million a week in VAT (value-added tax). These actions are estimated to cost the British government more than $2 billion a week in tax revenues.

□Washington Researchers, a research and publishing firm, has released its latest series of federal information and federal press release indexes. Since 1971 the amount of data generated by the government has increased by 96%, but the government's efforts to make this information public have decreased by 26%. "In practical terms this means that the government puts out a massive amount of information, but few people know about it," the researchers concluded.

□Department of Agriculture auditors discovered in January 1979 that both the Agriculture and Health and Human Services Departments had been reimbursing Philadelphia's Get-Set Day Care Program for labor expenses. As a result, the program received $478,000 more than it was entitled to. The GAO has since reported that because the agencies could not decide which one should go after the overpayment, "the funds have not been recovered and the day care operator is still being funded by both programs."

□President Reagan has again come under attack from the New Right on the grounds that he is not sufficiently conservative. Half of the February issue of *Conservative Digest* is devoted to questioning Reagan's commitment to conservatism by such notable figures as Jerry Falwell, Paul Weyrich, and Phyllis Schlafly. *Digest* editor John Lofton writes, "Your (Reagan's) mandate for change is in danger of being subverted. Your personnel operation is being run by individuals who are politically naïve and, worse still, individuals whose backgrounds reveal a hostility to most everything for which you have so strongly stood over the years." ■

district, what dollar money supply should it target? The supply of Atlanta Fed dollars? Dollars issued by the Atlanta Fed are held in wallets throughout the country. Deposits in banks of that district could be held by individuals and firms outside the area, such as GM in Detroit, congressmen in Washington, or dowagers in New York preparing for winter vacations.

What about the total supply of dollars in the Atlanta district? Individuals and firms in the Southeast hold currency from many other districts as well as bank deposits from throughout the country. So the dollars that originate in Atlanta affect more than just the Atlanta Fed region, and the dollars in that region are not all under the Atlanta Fed's control. The quantity rule is meaningless.

For the country as a whole, with substitution among monies, the relevant concepts of money demand are the demand for dollars and the domestic demand for money. The demand for dollars is now the total world demand for dollars. The demand for money in the United States is the U.S. demand for dollars and any other monies held in domestic portfolios. Notice that the conventional concept, the demand for dollars in the United States, is only part of each of these two demands, and its usefulness as an economic indicator is therefore very limited.

For example, in a monetarist explanation of the exchange rate, the concept applicable to exchange-rate determination is the total world demand for dollars relative to the total world supply. With diversified money portfolios the dollar/mark exchange rate is determined by more than just the U.S. demand for dollars and the German demand for deutsche marks. A change in the expected cost or risk of holding dollars, which affects the U.S. demand for dollars, should affect the foreign demand as well. Or if the demand for dollars is falling in the United States, say due to a decline in the expected growth of income, it is possible that expanding portfolios elsewhere could produce an offsetting increase in demand.

The fact that a change in expected cost or risk affects the composition of foreign as well as domestic portfolios further implies that the reaction of international money markets to such a change should be larger or faster than in its absence. Exchange rates should therefore exhibit larger variance in the presence of currency substitution. The larger variance in turn leads to higher bid-ask spreads or foreign exchange costs, which in turn raise the cost of conducting business under a flexible-rate system. These higher costs further reduce the attractiveness of a flexible-rate system.

The existence of diversified money portfolios therefore has important implications for the issue of which world monetary system works best. We can, for instance, keep the current system of competing national currencies. But if the currencies of two countries are close substitutes in portfolios, then for small changes in the money supply the monetary policies of these two countries cannot be independent. Only by continually changing the monetary policy by a sufficiently large amount to change the risk of holding domestic currency can the central bank achieve any degree of monetary independence. However, large swings in monetary policy will produce larger than expected swings in the exchange rate, raising business costs and lowering output. These large swings in monetary policy are precisely the type of monetary policy that even more traditional monetarists such Milton Friedman have argued against.

Alternatively, two countries whose monies are close substitutes in portfolios should be encouraged to coordinate their monetary policies as a bloc rather than moving in separate directions. The more currencies that are close substitutes, the larger should be the bloc. The high degree of substitution found between domestic and foreign money in the United States, Germany, and Canada suggests that the optimal bloc is probably almost the entire world. In other words, less time should be spent debating what quantity rule is appropriate for which country. Rather, attention should be directed to how once again to synchronize and coordinate monetary policies across countries. Such synchronization could be designed to rely on the votes of the market by adopting a price rule such as the gold standard. ■

INFLATION MONITOR

A quarterly feature of *Policy Report*, the "Inflation Monitor" shows the distorting effects on relative prices of government fiscal and monetary actions. All figures are expressed as annual rates of change, unless otherwise indicated.

	1980 Fourth Quarter	1980 Third Quarter	1980 Second Quarter	Average for Last Year
MONETARY SECTOR				
Monetary Base	10.3	9.9	5.2	8.3
M1-A	8.2	11.5	−4.4	5.0
M1-B	10.8	14.6	−2.8	7.1
M2	9.2	16.0	5.6	9.5
M3	11.8	13.0	5.8	9.7
Discount Rate (average)	11.8	10.4	12.4	11.8
Prime Rate (average)	16.7	11.6	16.3	15.3
PRICE CHANGES				
Consumer Price Index	3.2	13.8	4.9	10.9
All-Finished-Goods Price Index	7.6	12.2	6.0	11.3
Intermediate-Materials Price Index	19.6	6.4	5.2	13.8
Capital-Equipment Price Index	13.2	8.5	11.3	11.6
INDUSTRIAL PRODUCTION INDICES				
Consumer Goods	147.5	143.3	148.3	146.9
Producers Goods	150.3	147.2	146.8	150.9
Raw Materials	149.8	139.0	145.0	147.5
Ratio of Capital Goods Production to Consumer Goods Production (1967 = 1.00)	1.02	1.03	1.02	1.04

SOURCE: *Federal Reserve Bulletin*

PR Reviews

Wealth and Poverty by George Gilder. Basic Books, 1980. $16.95.

Gilder's work has received one of the most tumultuous and publicity-laden receptions in recent memory. The New Right has greeted Gilder as the new messiah of capitalism, *Wealth and Poverty* has moved up on the bestseller lists, and Gilder has established himself as one of the nation's leading supply-siders. Articles in liberal magazines, while sharply critical of Gilder, have enthusiastically proclaimed him *the* philosophical defender of capitalism. Some businessmen and free-market economists contend that this is because Gilder's arguments for capitalism are fundamentally flawed and thus easily refuted by anticapitalists.

Wealth and Poverty is basically an attempt to create a theology of capitalism by a curious synthesis of religious faith, psychosexual neo-Freudianism, and a metaphysically pretentious version of supply-side economics. Gilder's notion of capitalism is one that does *not* exclude massive state intervention in the economy. The basis and justification for his idea of capitalism does not rest on voluntary exchange but on faith and unilateral giving. In order for such a society to be successful it is necessary to preserve the male-dominated nuclear family, for without such an institution men are condemned to be lazy and immoral. Gilder's rather extreme version of supply-side economics fits into this picture by illustrating the need for work and productivity, of which only male breadwinners are capable. Gilder's analysis is seriously marred by sloppy reasoning, misuse of factual evidence, and unprincipled moralizing.

In spite of these flaws, *Wealth and Poverty* contains a novel and dynamic analysis of poverty that some readers may find interesting (this reviewer did). Gilder presents a somewhat controversial explanation of how the welfare state hurts the interests of the poor by destroying the institution of the family. This book is recommended only for this analysis or for whatever interest a work may have that William J. Casey (Reagan's campaign chairman) described as "...serving as an inspiration and guide for the new administration."

Reaganomics: Supply-Side Economics in Action by Bruce Bartlett. Arlington House, 1980. $14.95.

This is perhaps the most concise explanation currently available of the recent phenomenon of supply-side economics. The first 150 pages or so are a clear exposition of the theory and policy of supply-side economics as seen by a supply-sider himself. The second half of the book is a reinterpretation of American and world history in terms of the supply-side paradigm. Both the success of the American tax cuts of the 1920s and the early 1960s and the extraordinary economic development of such Third World countries as Hong Kong are explained by the ability of low marginal tax rates to generate savings and investment.

Advocates of the free market should resist finishing this book and proclaiming "We are all supply-siders now" because although *Reaganomics* is an excellent book for telling one what supply-side economics is, it is not an excellent book per se. What becomes clear after reading this book is that there is little or no theory behind supply-side economics. The theoretical content of the book contains nothing more than the idea of incentives and Say's Law, which has almost become a stale truism in the hands of the supply-siders.

Reaganomics is characterized by a shallow analysis of history. The boom of the 1920s, for instance, is explained by tax cuts rather than by the Fed's expansion of credit. Also, the continual use of charts and diagrams, although useful, makes the book somewhat tedious. Especially annoying is Bartlett's perpetual glee in reporting how tax cuts can increase government revenue.

In short, *Reaganomics* is recommended only as a reference work for those interested in supply-side economics. Do not look for anything about President Reagan in here; he is scarcely mentioned. The title is a curious misnomer, clearly adopted after Reagan's election to capitalize on the interest in his policies. ■

"To be governed . . ."

Both sides of the fence

Justice Department lawyers appear at the Supreme Court to defend federal strip-mining controls against claims of intrusion on states' rights; they're representing Interior Secretary Watt and his department. But Watt filed a friend-of-the-court brief in December on behalf of a conservative group taking the opposite side.

—*Wall Street Journal*, Feb. 27, 1981

Small potatoes

Congressman Henry Reuss asked about a $37 million program for roads in national parks and wilderness areas. Replied [Budget Director David] Stockman in a revealing aside about the scale of Government spending: "That may be an item we missed. The computers at OMB are programmed to round off at $50 million."

—*Time*, Mar. 9, 1981

Not mine, you idiot!

Distressing many economists—including several leading conservatives closely tied to the Administration—is what appears to be a deliberate, disproportionate cut in National Science Foundation financing for social science research and particularly for economics. . . .

Robert E. Lucas Jr. of the University of Chicago, whose pioneering, NSF-funded work on rational expectations laid the groundwork for the Reagan team's belief in the possibility of achieving rapid progress in taming inflation, terms the outsized cuts "a big mistake." . . .

Martin Feldstein, president of the National Bureau of Economic Research, . . . [which] derives roughly half of its $4 million research budget from the government, mainly from NSF grants, [says], "It has been an exemplary source of support for empirical research."

—*Business Week*, Apr. 6, 1981

2 + 2 = 5

Speaking as an economist, [Walter] Heller rejected the proposition put forth this week by Rep. Jack Kemp (R-N.Y.) whose Kemp-Roth bill is the core of Reagan's philosophy that Keynesian economic theory means economic chaos as usual. "Keynesian arithmetic is just as good as it always was," Heller said.

—*Washington Post*, Mar. 9, 1981

When will they ever learn?

Japan's cabinet approved boosts in public works spending and aid to small businesses hit by high interest rates, in hopes of spurring the economy. The package also seeks to stabilize prices by delaying increased electricity and gas rates. A similar program last September failed to head off economic stagnation.

—*Wall Street Journal*, Mar. 17, 1981

Helping the poor

The Carter administration, as part of a large increase in housing and community development spending, touted UDAGs as a "major urban initiative" to assist "severely distressed cities." . . . Tucson, Ariz., received $750,000 to assist National Semiconductor expand an assembly plant. San Francisco was awarded $2.6 million to help Safeway Stores Inc. build a new supermarket, parking lot and office space and another $2.66 million to rehabilitate four hotels. Norwalk, Conn., received $875,000 to build retail space and housing, including 28 condominiums.

Kansas City, Kans., got $13.4 million to prepare the way for a General Motors plant. Lake Charles, La., collected $873,000 to help build a 250-room Hilton hotel. Baltimore received almost $1 million to underwrite the purchase of 89 townhouses. Fall River, Mass., came by $2.2 million to help develop an office building for Aetna Life & Casualty Co. Beaumont, Texas, got $750,000 to help build another hotel.

—*Wall Street Journal*, Mar. 25, 1981

Keynesianism, supply-side, now creationism

The House yesterday overwhelmingly made Arkansas the first state in the nation to pass a bill requiring public schools to teach the theory that a Supreme Being created man along with the theory of evolution. . . .

Before the House vote, a handful of people walked a picket line at the Capitol to lobby for the bill's passage. One carried a sign that read "Creation science will promote better scientific research, national productivity and lower inflation."

—*Washington Star*, Mar. 18, 1981

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