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Fiscal Action to Influence Employment and the Price Level: Some Criteria

TAX FOUNDATION, INC.

The current debate on Federal fiscal actions to help stem inflationary pressures while paying for the war in South Vietnam revolves around the relative merits of tax increases or expenditure reductions. This pamphlet, fourth in a new series, furnishes some background for the current debate. It examines fiscal versus monetary policy and the problems of timing any needed actions.

This *Brief* consists of the major part of a statement made to the Subcommittee on Fiscal Policy of the Joint Congressional Economic Committee on March 16 by C. Lowell Harriss, the Foundation's Economic Consultant and Professor of Economics at Columbia University. The views expressed are Mr. Harriss' own.

Tax Foundation is a private, non-profit organization founded in 1937 to engage in nonpartisan research and public education on the fiscal and management aspects of government. It serves as a national information agency for individuals and organizations concerned with government fiscal problems at the Federal, state and local levels.

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Opportunities and Problems

Expediting Fiscal Actions

These hearings are concerned with the timing of tax and other fiscal actions, specifically assuring fast action. Why may speed seem so important? Emergencies which are both sudden and large may demand action — the outbreak or the ending of hostilities or a big surprise in international affairs. The problem today, however, centers upon less extreme cases. One might almost call them "normal" features of modern life. They do not quickly generate urgent demands for action. But should we not prepare to deal with them more speedily?

Postwar ups and downs in business have been moderate. The forces of cyclical cumulation, of snowballing, self-propelling expansions and contractions, have been moderated by automatic fiscal stabilizers and by other factors. In combination these seem to protect against "boom and bust" of the type we feared after the Great Depression. The reason to seek speed in fiscal action does not lie in the need to protect ourselves against forces which, "left to themselves," would produce calamitous depression or wildly distorting boom. But there is a persuasive reason — to reduce avoidable losses of well-being because of delay in putting better policies into effect. Should we not try to improve upon achievements to date? Losses of real income have been needlessly large. One explanation may be the lack of urgency. When almost everyone prospers — or if any impending price-level increase is associated with the attractions of generally rising *real* income — can one expect a groundswell of public support for policy changes? Any obvious benefits might accrue predominantly to others. Normal inertia, plus fear that change might bring unintended disappointments, can lead to costly delay.

Some Problems of Action

The less-than-extreme economic illnesses can be of many degrees and kinds. No two situations will be identical. Trouble results from a complex mixture of causes. Nevertheless, fiscal action of a broad, aggregative type can be helpful. The *direction* of desirable action will ordinarily be clear. Here is knowledge of tremendous value. Speed in using it ought to be better than delay. Yet gaps in our understanding remain. Neither the optimum *amounts* nor the best *duration* of a policy will be clear. Overshooting the mark cannot be ruled out, nor can undershooting.

Any *general* policy (macro) takes concrete form only as *particular* acts (micro). A total of any given dollar amount — a $5 billion change in taxes — may consist of any of several combinations of parts — various kinds of tax revisions. All combinations may produce results which are better than if nothing were done. Some combinations, however, may be much better than others. And some may lead to less desirable results than inaction.

One possible method of speeding action would set a general rule to be applied more or less automatically. Another would grant a significant element of discretion (but within some limits) to a person or a group. I pass over the political aspects of changing the locus of power to change tax rates and focus on more purely economic considerations.

In the present state of economic knowledge, I doubt that a rule set in advance could be counted upon to do more good than harm as compared with action — or inaction — based on contemporary response to conditions as they develop. (1) The events which actually unfold will have elements not foreseen, *e.g.*, changes in the balance of international payments. (2) A rule set in advance would not benefit from the "learning curve" of experience. (3) If a general rule, perhaps modified by discretionary power, were on the books, its mere existence might add to delay (compared with what would otherwise occur). And would it not impede adjustment of amounts when the "ideal" seemed to lie beyond the limits? (4) The upward secular trend in revenues creates a presumption that any measure of appropriateness will get out-of-date; but no one can predict the amount for the years ahead without knowing, among other things, the future of Federal spending.

(5) Discretionary or formula-based power to raise tax rates during boom would reduce pressures to restrain expenditures. (6) What does one know about the competence of the men who would have the power and the conditions under which they would make choices? (7) Congressional and public debate can have educational value for understanding the varied developments of the moment as well as forces of continuing significance. The job of education remains formidable. Economists probably do know a great deal about the effects of fiscal action. But a little contact with work at some of the frontiers of research will inspire — compel — caution in prescribing for society in conditions yet to develop. (8) Finally, the effects of any fiscal action will depend upon monetary conditions, and they cannot be predicted with near accuracy.

Interrelation of Monetary and Fiscal Policies

Any changes in Federal revenues or spending will alter the stream of money payments. Perhaps the adjustment will be a simple substitution of one use of money for another. Two other possibilities carry more potential "punch" — changes in the stock of money or in the rate of turnover of existing dollars. Movements of the level of national income depend not only upon fiscal, but also upon monetary policies.[1] Every business day the Federal Reserve by action (e.g., open-market operations) and by standing ready to act on certain terms (e.g., to lend to member banks at a discount rate announced in advance) influences the money-creating capacity of banks.

Money Counts

Fiscal and monetary policies are by no means perfect substitutes for each other. They are not fully interchangeable. Nevertheless, the effects of any fiscal policy must work out in an environment which depends significantly upon monetary policy.

Both public debate and advanced professional analysis often benefit from assuming "other things being the same." Real-world processes, however, do not permit the simplification which involves a fiscal policy change having no monetary effect. Economists disagree in their weighting of the relative importance of monetary and fiscal actions under different combinations of conditions. Such differences of view, however, do not justify what sometimes seems to be the denial, by implication, that monetary policy will significantly influence the outcome of fiscal action.

In assessing the effects of the 1964 tax cut, many observers have made no explicit allowance for changes (1) in the stock of money and (2) in velocity of circulation. Yet the compounded annual rate of change in the money supply rose from 1.8 percent (mid-1960 to Sept. 1962) to 3.9 percent (to June 1965) and to 5.9 percent up to February 1966. The annual rate of turnover of demand deposits rose from under 30 in 1961 to around 35 in mid-1963 and 51 in February 1966. Interpretations of the economic sluggishness of the late 1950's which focus on fiscal developments may also oversimplify. Growth in the stock of money slowed and for a time even became negative.

Who can possibly judge the effects of different possible fiscal actions next month or next recession without making assumptions about monetary conditions? The leaders of our government have the potential power to assure themselves of a much higher degree of certainty about monetary policy than has been the case to date. True, velocity of circulation will remain beyond direct control of official agencies. But changes in the stock of money — defined as currency plus demand deposits — can be controlled within a moderate range, not necessarily from week to week but for periods short relative to phases of a business cycle. Changes in the amount of money added to the economy do more than influence interest rates when newly created deposits add to the supply of loanable funds as the money is injected into the economy. The money continues to exist, to pass from hand to hand, to be used in transactions.

Can Monetary Policy Meet the Need for Speed in Action?

Decisions on monetary policy can be made and put into effect upon very short notice. But the full results take longer. Monetary policy can do much — but not all we might wish to supple-

[1] Monetary policy can be identified with Federal Reserve actions which influence (control) the ability of banks to create the demand deposits which constitute most of our supply of money. Relevant also are other actions which influence liquidity but not the stock of money as defined strictly. Other policies, notably those affecting wage rates, also influence employment and price levels. The higher the level of average wage rates, the greater the dollar total of demand needed for any total of employment. Raising the minimum wage and extending coverage would aggravate the problems of achieving full employment with price-level stability. The resulting wage-rate structure would obstruct the absorption into the employed labor force of young people and others whose productivity has not yet reached the legal minimum.

ment automatic fiscal stabilizers. The monetary authorities cannot be expected to act with the timing and in the amounts which will provide all of the balancing desirable to sustain prosperity without inflation. Yet the reasons which lead to this conclusion argue with at least equal force against hoping that discretionary fiscal policy can offset the timing inadequacies of monetary policy. Difficulties of forecasting and of allowing for lags are present in both cases.

Improving Coordination in the Formulation of Fiscal and Monetary Policy

Fiscal policy results from (1) the recommendations of numerous elements of the executive branch, (2) the actions of revenue-raising committees and the appropriations committees (and their subcommittees) in both House and Senate, and (3) the houses of Congress themselves. Monetary policy is made by the Federal Reserve subject to an undeterminable influence from the executive branch, Congress, foreign central banks, and other sources.

An outsider cannot evaluate the "real-life" working of these arrangements. But I have read much of what has appeared in print. It makes me uneasy. The men who have made the decisions do not seem always to have understood the issues, processes, mechanisms – including the ties between monetary and fiscal policies – as well as we should like. Perhaps, however, the past is a poor guide to the future. Will not everyone have learned? Unfortunately, some of us are slow learners. Even more to be regretted, the "truth" is not always crystal clear.[2]

The validity of one point, however, seems beyond question: The public may justifiably expect that the two groups of decision-makers coordinate policies. Where arrangements fail to assure coordination, what needs to be done? My few suggestions assume no major change in relations among the branches of our government.

The Decision-Makers' Need For Facts and Analysis

The improvement of information available to policy-makers represents an achievement for which the Joint Economic Committee and its staff deserve the country's thanks. More remains to be done in providing evidence about what has (just) happened and in analyzing the probable results of alternative courses of action.

Congressional hearings advance understanding. Nevertheless, they cannot do all that is reasonably possible in threshing out tough questions – and many are tough. The public forum has some disadvantages as a means of examining complex and controversial issues. "Second thoughts" cannot get into the discussion when there is no second round. How can any committee of Congress be certain that it is getting the full and complete thinking of Federal Reserve and executive agencies, with articulation of doubts and differences of view among the men and women with a rightful claim to competence?

One possible procedure for strengthening the basis for decision occurs to me. Might not the contacts between the professional staffs of Congressional committees, executive agencies, and the

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[2] Among the many complications are some which grow out of the existence of Federal credit programs. Sometimes credit financed from the savings which the public makes out of income will cost more, the market rate of interest is higher, than beneficiaries of the program expect. Then the pressure for money creation to provide funds can be strong indeed.

Federal Reserve be developed more fully?[3]

Getting the Entire Fiscal Picture — Accurately

Fiscal policy includes spending as well as taxation. Problems of the economy as a whole (macro) require the comparison of (1) expenditures as a whole with (2) taxes in their totality. January's budget offers the nearest thing we have to a means of doing so. Within days, however, it begins to get obsolete. For most of the 12 months no one has estimates of the relation of future revenue and spending which are free from a significant range of uncertainty.

Thinking of taxes from the point of the effects of revenue totals on the economy as a whole got support during the 1963-64 discussions of tax reduction. Spending decisions, however, are made by a process which gives no apparent consideration to the aggregative effects, i.e., action is taken on particular programs (in substantive legislation and later in appropriation bills), not on the whole.

Concern for balancing the budget may, or may not, once have had meaningful effect in getting Congress to take account of totals of prospective taxes and expenditures. Be that as it may, I suggest that advocacy of abandoning the balanced-budget guide has strengthened the forces which deprive us of an effective means of determining spending in total in relation to revenue totals.

Might procedural changes enable Congress to consider, and perhaps even act upon, the total of spending decisions as a unit? Some students of the problem believe that such a revision of procedures is not out of the question.[4] One reason for endorsing such action might be the possibility of improving fiscal policy to serve better as an aid for influencing the total level of economic activity.

Other problems call for attention. How do receipts from the sale of assets, or from a speed-up in collections, compare in economic effect, per dollar, with tax revenues? What, if any, spending or credit policies are likely to encourage money creation and thus exert more stimulating (inflationary) effect than indicated in the budget figure?

What Kinds of Fiscal Changes: Observations About Choices

Purely Countercyclical Actions

If there is to be fiscal action for purely short-run countercyclical needs, changes in the personal income tax seem the best. Alternatives are few. Adding and removing excise taxes would involve administrative and compliance problems of some magnitude; changes large enough to bring much revenue would tend to alter the timing of consumer buying enough to be destabilizing. Raising and lowering the rates of existing excises would be administratively simpler but would discriminate among industries and consumers on the basis of consumption patterns. Changing payroll tax rates would involve issues of Social Security financing, direct alterations of (additions to) business costs, and burden distribution which

[3] Representation of the minority party would be desirable, and probably essential for maximum effectiveness in expediting action.

[4] See Tax Foundation, Inc., *Controlling Federal Expenditures*, New York, 1964, especially pp. 27-44.

combine to lead me to oppose such action for short-run stabilization.

Raising and lowering the corporation tax rate would complicate business management, especially investment planning and in some cases (e.g., regulated public utilities) pricing. The distribution of burden would be — well, what would it be? No answer to the question is clear, a fact which provides one reason for my vote against this possibility. However, gradual reduction of the corporation tax rate over time seems to me highly desirable; therefore, some reduction when economic stimulation is called for would get my vote — but not increases. Such apparent lack of symmetry would perhaps need some "selling effort" to make it politically acceptable. As to the investment credit, I do not see how it could be granted, suspended, granted again, etc., without adding to instability and giving rise to problems of inequity among companies; in its present form the credit has technical features which greatly impair its potential usefulness as an anticyclical device.

Expenditures

Dollar for dollar, government spending may, or may not, have greater influence (macroeconomic) upon jobs and the price level than do taxes. The predominant opinion among economists seems to be that spending has more effect per dollar; if so, putting the brake on inflation requires fewer dollars of restraint through the spending than through the taxing route. Moreover, the nearer the economy is to full employment, the less its "ability" to "afford" Federal expenditures; real costs as sacrificed alternatives are generally higher when the economy is operating at essentially full capacity than when Federal spending brings into use productive capacity which would otherwise be idle.

Short-run expenditure change for countercyclical purposes presents difficulties which I shall not attempt to review. But as cycles come and go, trends continue, and Federal spending trends are upward. Every year many major (nondefense) spending changes are under consideration. The scope for choice about (1) *adoption* and (2) *scale* is not trifling. New programs are now being advocated. The Administration supports expansion of others, and Congress has shown willingness to boost outlays and oppose cuts endorsed in the budget. For some programs the President has recommended no reduction when some contraction might be better than tax rate increases. For example, how much spending now advocated for this period of boom results from programs originally justified to a large extent as methods of stimulating an underemployed economy?

For the near term we wish to reduce upward pressures on the price level. Federal buying (and transfers) account for part of such pressure. It can be reduced. Yet anyone proposing to check the growth of expenditure must expect the question, "Well, just where in the budget would you cut?" If he answers with "specifics," he seems to have assumed a heavy burden of proof, one involving details about a variety of matters greater than anyone's range of competence. The supporters of the programs can "zero in" against him while the rest of the country occupies itself with more congenial activities than supporting the advocate of expenditure restraint.

The following points seem to me worthy of consideration now:

(1) Identify those types of Federal

spending (indirect as well as direct, including credit programs) which raise costs and prices, not only "in general" but more especially on those things for which the money is being spent. Construction comes to mind at once. But there must be other cases in which the supply of the inputs is "tight" (relatively inelastic) so that more than a small fraction of the increase in outlay goes into higher unit costs. Perhaps special attention could be given to those cases in which private businesses — and philanthropies — suffer from the competition of Uncle Sam's "long purse."

(2) Delay can offer leeway for easing near-term pressure on the economy without abandoning projects indefinitely. Postponement of some new construction, even if only a few months, would relieve immediate pressures.

(3) Decisions on some expenditure in the budget were made several months ago. Conditions were not like those we face now. (a) The evaluation presumably assumed that no increase in tax rates would be required to pay for these projects. But if tax rate increases come to seem necessary, the original justification for the spending can hardly stand in all cases. (b) The rise in market interest rates reflects a new evaluation of the present as compared with the future. Application of today's interest rates in the reappraisal of expected benefits from long-lived projects would show that on the basis of the criteria used to justify them originally some are not warranted at this time; a dollar of benefit receivable in 30 years is worth 31 cents now if discounted at 4 percent, 17 cents with discounting at 6 percent.

(4) We now look to even greater prosperity than assumed in preparing the budget. The country should be able, therefore, to do a little more privately (and through state-local governments) to pay for what it wants. There is less need for Federal action which rests to some degree on the argument that redistribution is desirable or that a sluggish economy needs stimulation.

General Versus Pinpointed Tax Changes

When tax rates are high, when total tax collections are large, and when the revenue structure is complex, economists can suggest tax changes which, per dollar of revenue, will exert relatively large influence of one or another specific type. Some tax changes will seem to be better suited than others to the specific needs of the moment. Pinpointed actions may appear to be most efficient. Nevertheless, for reasons which space limits do not permit me to develop here, the presumption seems to me to be against special features of tax law. The need for the near future is for general restraint. If higher taxes seem called for, broad policies are to be preferred. Their effects will be most consistent with overall efficiency in resource allocation.

A still more general goal appeals to me strongly: Every tax change should make the revenue system more like that with which we should like to live indefinitely. Even changes made for emergency, and apparently temporary, purposes should be consistent with, and if possible an element of, a program of long-run tax reform. No blueprint for long-run tax reform can be expected from any deliberations now foreseeable. Yet as Congress and the executive face issues of tax change, explicit consideration might well be given to the question, "Which alternative will fit best into the plan for the tax system which we wish to pass on to our children?" A recent article summarizes my preferences.[5]

The Treasury, according to reports, favors "neutral" change if any action is required soon. By neutrality it apparently means equal percentage change in personal income tax liability at all income levels plus approximately the same relative change in corporation tax rates.

The argument for neutrality is political rather than economic. If speed were highly important, sacrifice of the possibility of improving the tax structure might be worthwhile if doing so would reduce controversy and hasten action. But how urgent, really, is the need for speed? My hunch is that the outlook is not such that a few weeks or even months more or less in enacting a tax law will make much difference in the price level. Can we not "buy" some of this time by monetary restraint?[6] Delay in tax action might induce the monetary authorities to make fuller use of their powers, a policy I would prefer to near-term increase in tax rates. Moreover, delay in a decision on tax change might — or might not — add an indirect restraining force: perhaps an early agreement to raise taxes would weaken any resolve to slow the increase in appropriations.

If short-run needs call for very quick action, an equal proportionate change in personal income tax liability would meet my criteria of desirable change tolerably well. Such action would not offset at very low income levels the effects of the erosion of the purchasing power of the personal exemption; the narrowness of brackets and the resulting steepness of progression would remain; the top bracket rates would be increased rather than reduced as seems to me desirable for the long-run; special provisions which I dislike would continue, and no "improvements" would be added. Yet an imperfect world requires compromises.

Boosting the corporate rate, however, would get, not my endorsement, but condemnation. Progress in taxation, I believe, requires gradual reduction in the corporation rate. Even a "temporary" increase would work against the general welfare.

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5 C. Lowell Harriss, "Tax Revision: Problems for the Long Run," *Tax Review*, Feb. 1966, Tax Foundation, Inc.

6 Perhaps a start has already been made in slowing the rate of growth in the stock of money. The February figures are certainly consistent with a reversal of policy. Only as the weeks pass, however, can we be certain.