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CAN TAXES FINE-TUNE THE ECONOMY?

by Lindley Clark

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When our nation was founded two centuries ago, there really wasn't any national tax system. Things have been going downhill ever since.

Actually, of course, some things haven't changed. Lacking the right to impose direct taxes on the public, the government borrowed money and inflated the paper currency, a tactic that is still used from time to time.

Even after the government acquired the right to impose taxes, its purpose for a century and a half was only to support what were regarded as the necessary functions of government. As the ideas about necessary functions expanded, so did the taxes. Finally the tax system became so large that many people, both in and out of government, decided that it could serve a number of other purposes.

The tax system, it was decided, could eliminate or at least reduce inequalities of income and wealth. I don't propose to defend or attack progressive taxes or inheritance taxes here; that's beyond the scope of my talk. I will only note that the inequalities somehow still survive despite the incredible complexities that have been written into the law to reduce them.

One of the problems has been that government has also decided that the tax system can be used as a handy incentive to prod businessmen and individuals into doing supposedly desirable things. Tax measures can easily conflict with one another.

For instance, the interest on state and local securities is exempt from federal income tax. This exemption is of course a subsidy to state and local governments, which Washington appears to regard as desirable institutions. But it also is an incentive to individuals and companies to buy state and local securities. Recently it wasn't enough of an incentive to induce many people to buy New York City securities, but the intent is there.

The incentive obviously is most attractive to persons in higher tax brackets, who thus are able to insulate part of their income from progressive taxes. So Congress has passed a minimum tax law to stipulate that everyone with substantial income must pay some taxes, whether the rest of the law says he should or not. And the tax laws grow ever more tangled.

The twisted state of the tax law creates complications when the government decides, as it often does, to use taxes to try to fine-tune the economy. Tax law is not simple and clear, and every time Congress takes a new look at it, the legislators decide that it's time for reform. Congressmen feel a little guilty that even Americans of modest means often feel that they must hire professional help to prepare their returns.

In the best of circumstances Congress seldom can pass major legislation overnight. When the lawmakers start trading ideas about reform, tax changes are likely to take a long time.

So the first objection to using the tax system as a tool of economic management is that it is a very clumsy instrument.

im•pri•mis (im-prī´ mis) adv. In the first place. Middle English, from Latin in primis, among the first (things). . .

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The clumsiness stems from more than the law's complications. In our system of government the administration may propose tax changes but the Congress disposes. In the parliamentary system things are supposed to be a lot simpler. The government proposes a set of changes in the tax laws and if parliament turns it down, the country has to get itself a new government.

In the mid-1960s the President's Council of Economic Advisers and the President recognized that the combination of an acceleration of the Vietnam war and the new Great Society programs was straining resources and that a tax increase might be a good idea. But Mr. Johnson knew that if he told Congress he needed a tax increase Wilbur Mills would tell him that he had another way to put the budget in better shape: cut down on the Great Society.

So, for reasons that were certainly understandable, *if not correct*, Mr. Johnson put off asking for a tax increase. The income surtax was finally enacted in 1968, long after the inflationary pressures had been building up.

That episode illustrates another one of the problems with using taxes to fine-tune the economy. When the tax was finally enacted, economists at the Federal Reserve System and nearly everywhere else assumed that it would slam the brakes on the economy. Consumers would suddenly find themselves with considerably less disposable income so they would slash their spending on houses, automobiles and television sets.

But things didn't work out that way. The public had been told that the surtax was temporary. So instead of cutting back on their spending, consumers drew on their savings and largely maintained their spending levels.

But the miscalculation was more than a mere classroom mistake. The economists at the Federal Reserve were so convinced that the tax increase would really sock it to the economy that they counseled the Fed officials to speed up the growth of the money supply to offset the damage to the economy. So whatever anti-inflationary gain was achieved by the tax boost was pretty much washed out by a flood of Federal Reserve money.

To recapitulate, we've already got three strikes against the idea of using taxes to fine-tune the economy. First, the tax law is so complicated that changes are difficult and may have unintended effects. Second, changes take so long that they may not be made in time to serve their intended purpose. Third, the effects of tax changes on the public are still not completely understood. In baseball three strikes are out, but in politics an idea can survive a great deal more than that.

But now let's suppose that we solve those problems. To do so we're going to have to assume that some political obstacles can be eliminated, but let's try it. Many economists long have urged that the government, or rather the administration, should have a limited power to change income tax rates whenever it decided that such a change was wise. In this way you would get around all of those congressmen who want to reform the whole Revenue Code every time you look at it.

I'm not at all sure that anyone is ever going to persuade Congress to let go of even that much of its taxing power, but let's just assume that it will. That change also solves the question of speed: you get a nice simple change, quickly effected.

The third problem is a little more difficult. We have learned a lot about the effects of tax increases and decreases over the years. In the early years of the Great Depression the Roosevelt administration raised taxes several times in an effort to balance the budget. It didn't occur to anyone that the tax boosts would discourage private spending and help to make the Depression even worse.

As the 1968 experience showed, you can't really count on a temporary tax cut to accomplish what you want. One way around that problem is to pretend that it isn't temporary. That's the tack that the Kennedy administration took in the early 1960s when it introduced the investment tax credit. The administration thought of the credit as a temporary way to spur increased spending on new plants and equipment.

However, businessmen were suspicious of a temporary credit. After all, it can take several years to plan a new factory and get it into production. So, to get the effect they wanted, administration officials told businessmen that the credit would be permanent. It worked very well; there was indeed a surge in plant and equipment spending.

And of course no politician of either party really has to keep all of his promises. A few years later the investment credit was cut back with the aim of cutting capital spending. It appeared to work, too. Any projects that could be postponed were postponed. After all, the credit might be restored a little later on, and indeed it was.

But you can't always count on the credit. The increase earlier in 1974 did not bring forth a lot of new capital spending. It would be wrong, however, to say that the credit has had no effect. Without it, the cutbacks in capital outlays might have been even more severe.

Anyway, we're going to assume that government economists will be able to predict correctly each time the effects on spending of any of our simple and instant changes in the tax law. If we assume these problems away, does that mean we can then use taxes to fine-tune the economy?

No it doesn't. In our little exercise in make-believe, we've given the administration the power to make instant tax changes when it chooses to do so. But taxes are not all-powerful and, if you believe Milton Friedman, not even most powerful.

Over on Constitution Avenue in Washington there are two lovely white marble buildings that house the Federal Reserve Board, the central authority of the Federal Reserve System. Presidents appoint members of the board, but members' terms run fourteen years. Very often board members are still around long after the presidents who appointed them have departed.

The Federal Reserve is an independent agency. That doesn't mean it's completely independent; it merely means that the president can't give the Fed orders. There was a report a year or so ago that Arthur Burns was getting some suggestions from the White House by telephone, but I have it on his word at any rate that the report wasn't true.

The Federal Reserve, however, is responsible to Congress. Congress has been tugging on the leash a bit in recent months, too. The House and Senate passed a joint resolution asking the Fed to spell out its targets for the growth of the money supply a year ahead, and to the surprise of some people the Fed has complied. In the year ending with the second quarter of 1976, the money supply is supposed to grow at a rate of 5% to 7½%.

Just how that target will be hit, if it is, is very much up to the Fed. The Federal Reserve believes that it doesn't matter if monetary growth varies widely from month to month, or even from quarter to quarter, as long as everything averages out properly over longer periods.

So we've given the administration the power to make these instant tax changes, and anything the administration does may be offset by something that happens over on Constitution Avenue. You don't have to be a monetarist to know that a tax cut won't spur a lot of economic activity if the Fed dries up the money supply and permits sharp increases in interest rates.

You may say, quite correctly, that the people at the White House and the people at the Fed all supposedly have the best interests of the country at heart. But there are now a number of widely varying ideas about what the country's best interests really are. Some economists think that the first priority should be to get unemployment down, while others think that the best hope for employment in the next few years is to get the inflation down now.

The Federal Reserve wouldn't say it so flatly, but at the moment it is concerned mostly about inflation. In testimony prepared for a congressional committee, a friend of mine said that the money supply should grow at a rate of no more than 5½% a year. A committee staff member told him, "You can't say that. You're below Arthur Burns. Nobody is below Arthur Burns."

So if we want to use taxes to fine-tune the economy we've got to make sure that monetary policy isn't playing its own little game over in a corner, defeating everything we're trying to do. We've already assumed away several problems, so let's assume this one away too.

This suggestion really isn't so radical, at least not for other countries. All that we have to do is to take away the Federal Reserve's independence. Perhaps we make it a branch of the Treasury. Thus we will have given the administration planners the power to change taxes at whim and to decide just exactly what monetary policy to follow. Can we then use taxes to fine-tune the economy?

No. I hate to be stubborn about this, but we've still got problems. One of these problems is simply the matter of statistics. If we're going to fine-tune the economy, we have to know what the economy sounds like now. The way things are, we don't even know what it sounded like yesterday or even last month.

It's partly just a matter of the size and complexity of the economy. There's so much going on that by the time you've counted everything you have a handful of ancient history. Inflation has complicated matters even more. The statisticians have formulas for converting nominal dollars into real dollars, but formulas were devised when we thought 4% lation was a lot of inflation.

Not very many people can get excited about the ed for better statistics. A lot of people get excited out statistics, of course. The increases we've had the consumer and wholesale price indexes in ent months have stirred up everybody.

And that's a case in point. The consumer price lex measures the prices of a market basket of ods and services bought by a typical urban worker 1960-61. That's right, 1960-61. The Bureau of bor Statistics took another survey in 1972-73 of w urban workers were spending their money, but it survey won't be reflected in the index until 77.

Spending patterns do change. Every time the BLS kes a survey some things get taken out of the rket basket and others get added. The last survey, instance, threw out long woolen underwear. Then ere's that matter of urban workers. How they end their money and what happens to their prices l not always reflect the national average. I'm not ying that the current CPI is a poor reflection of ces generally; I simply don't know, and neither es anyone else.

Or look at the wholesale price index. The index vers a huge assortment of goods. There are a lot problems in collecting the figures. In the cir- mstances, it is certainly understandable that the reau of Labor Statistics uses list prices for many mmodities. List prices, of course, may not always lect the prices at which goods are actually sold.

At the moment, for instance, many businessmen lose a little sleep at night worrying about the possible return of price-wage controls. If controls return, they would like to have their list prices as high as possible; after all, they won't be arrested for cutting prices.

There is no way to know for sure, but it's a safe bet that some of the price increases we've had lately in steel, aluminum and the like were motivated to some extent by the fear of new controls. And the new list prices in months ahead may not always reflect the prices at which goods are actually being sold.

Herbert Stein, who is going to be speaking here later this week, recently urged a substantial increase in government spending on statistics. He estimated that the outlay now was about $300 million, and that this should at least be doubled. Whether or not you want to fine-tune the economy, it would be nice to be able to recognize the tune it is playing.

So suppose we spend a lot more money on statistics. Are we then home free? Unfortunately, no. We have a lot of fine economists in this country, but none of them really understands completely how the economy works. A little earlier in this exercise we assumed that our fine-tuners would know the effect of a tax cut on spending by businessmen and consumers. But we don't know what the tax cut will do to such things as inflationary expectations and interest rates.

In the past forty years economists have developed a lot of models to forecast how the economy works. Several years ago one of the editors in our Washington bureau told a reporter that the Commerce Department had built a model of the U. S. economy. He told the reporter that he should go over and see how it operates. What he had in mind was some sort of scale model complete with railroads, trucks and tiny factories puffing smoke.

Models, of course, are sets of equations expressing the relationships between economic variables. With the help of computers these equations can be solved to produce forecasts of gross national product, interest rates and almost anything else. Because this exercise leans heavily on both economics and measurement, it has been called econometrics.

Like economics, it is not as yet an exact science. One of the pioneers in this area, Alfred Cowles, got interested in econometrics largely because he thought he could use it to predict the stock market. Unfortunately, the stock market remains one of the numerous areas of the economy that can't always be predicted with any degree of precision.

I don't propose to condemn econometrics. When you are aware of its limitations it can be enormously useful. Much of the work that has been done and is still being done to determine how the economy does work has been made explicit in model equations.

When an econometric forecaster tells you that the gross national product is going to be $1 trillion dollars, you can look at his equations and find out how he reached that result. When a forecaster who relies only on his judgment tells you the same thing, you don't know how he got there. He may turn out to be right for all the wrong reasons.

Perhaps the biggest weakness of econometrics is a very human weakness. The model maker has to assume that history is going to repeat itself. All of his equations are constructed on the basis of the way the economy has worked in the past. The models can't always contend with the surprises that so often seem to come along.

The fall and winter of 1973-74 provide one example. The Arab oil embargo and the quadrupling of oil prices were severe and unexpected shocks. There was nothing in history that provided any sure guide as to just how the economy would react. The forecasters guessed that it would take a while for the higher prices to work their way through the economy, but then when the Arab embargo was lifted the economy would begin moving upward, probably about the middle of the year.

The econometric models, along with the judgmental forecasters, predicted that interest rates would ease, at least until the economy began improving in the last half of the year. Somehow things didn't work out that way.

Businessmen began preparing for a new boom, stocking up on inventory and creating shortages even where none existed. They borrowed heavily from banks, and their borrowing brought a sharp rise in interest rates, not a decline. The inventory-building added to the upward prices pressures, and inflation got worse. About mid-year the Federal Reserve System came in to try to do what it could to stop the inflation; it put the brakes on the growth of the money supply.

Arthur Burns claims that tight money in 1974 didn't have anything to do with the depth of the recession that fall, and there are a few people around who agree with him. There has been a lot of talk about the lags in monetary policy. The econometric models naturally have to make assumptions not only about how policy changes will affect the economy, but how long it will take them to do so.

Some economists think now that inflationary expectations have become so thoroughly imbedded in all of us that it now takes less time for Fed moves to affect the economy. They point out, too, that more people, especially in financial markets, are acutely aware that what the Federal Reserve does every day may have some effect on both prices and business.

Watching the Fed has become almost a new profession in Wall Street. It has acquired a high degree of sophistication, or if you prefer, foolishness. When the money supply suddenly shoots up, that development no longer leads anyone to think that the Federal Reserve wants easy money. The Fed watchers generally assume that the Fed has made a mistake and that it will move next to shrink the money supply and possibly push up interest rates.

The economy is in a highly nervous state. I've never seen a wider range of forecasts about the economy. I know some economists who think the gross national product may very well decline in the next quarter, and I know others who think it will grow by 7% or 8%. That's not a period off in the distant future; it's the quarter that begins next Wednesday.

Businessmen, consumers and financial institutions are in weak financial condition. Inflation has been chewing away at incomes and wealth. Everyone is heavily loaded up with debt. When a patient is nervous and weak you put him to bed in a quiet room and try to avoid any sudden shocks. I would suggest that the U. S. economy could stand a little rest and quiet too.

The Federal Reserve has the right idea. At least it seems to be trying for reasonably steady growth of the money supply. Fiscal policy may be something else again. The big budget deficits aren't going to go away for a few years even if Congress avoids new tax cuts and sharp increases in spending. I would hope that we could continue to work our way back toward a balanced budget and not suddenly start heading the other way again.

If you haven't guessed it by now, I don't think that we're smart enough to know how to fine-tune the economy. That best-selling author, John Kenneth Galbraith, once suggested that the president needed a better grade of economic advisers. He thought about suggesting that the last ten presidents of the American Economic Association serve as an advisory board to the president. But then he remembered who some of those economists were and decided that wasn't such a good idea.

One of those presidents was Milton Friedman. Professor Friedman is one of the more vocal opponents of efforts to fine-tune the economy. In his area of monetary policy, he long has urged that the money supply be allowed to expand at a moderate and steady rate, regardless of what is happening in the world about us. He argues that the Fed's insistence on a flexible policy, designed to stimulate the country out of recession or to cool off a boom, has led the system to do too much too late, and thus to widen the cyclical swings in the economy.

Professor Friedman also favors a budget that's always balanced at full employment. The full employment budget is a slippery idea, but it can be a useful one. If a real effort is made to achieve such a budget, the fiscal shocks on the economy will be lessened.

Professor Friedman is quite happy to agree that if we ever do understand the economy thoroughly enough we certainly should try to see to it that it always operates in desirable ways. If we could forever abolish recessions and inflation, we obviously ought to do it.

But a lot of the disturbances that now occur in the economy are produced by the government itself. Lyndon Johnson, after all, insisted that we could have both guns and butter in the mid-1960s – without paying the full bill – even though some of his own economists were telling him it wasn't so.

We do know how to fine-tune the government. The job may be hard to do politically, but the knowledge already is there. What would happen to the *private* economy if we took as our first aim the stabilization of the government itself?

No one can say for sure; it's never really been tried. Professor Friedman and a number of other economists of the monetarist persuasion think things would work out pretty well. They believe that the private economy, if left to itself, tends to be inherently stable. It is subject to occasional fluctuations for various reasons, but it tends to return to stability rather quickly.

This argument got support from a surprising quarter a couple of years ago. Otto Eckstein, the Harvard economist who was a member of the Council of Economic Advisers in the early 1960s, has helped to formulate some of the early ideas on fine-tuning. However, he ran a test with an econometric model to get an idea of what would have happened in the 1960s if both fiscal and monetary policy had been stable.

On the monetary side, Professor Eckstein assumed that nonborrowed bank reserves had grown at a steady 4% a year. On the fiscal side he assumed that the full employment budget had always been in balance or close to balance. In fact, both monetary and fiscal policy had been highly erratic.

What would have happened? There would have been less inflation. There would have been about the same average unemployment, but the pattern would have been more stable. There would have been about the same real growth, but once again the pattern would have been more stable.

Professor Eckstein correctly stressed the difficulties of stabilizing government, including the political problems that we have already mentioned. He also said, in effect, that econometrics isn't conclusive proof of anything. But he did find his results intriguing.

So do I. The problems of stabilizing the government are much the same problems that we face when we try to fine-tune the economy. Large and complex as the government is, it still is not as complicated as the economy.

Wouldn't it make sense to try to stabilize the government first?