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A FISCAL APPROACH TO INFLATION AND GROWTH

INTRODUCTION

The virulence of inflation cannot be measured solely by changes in the consumer price index or tightened family budgets. A subtle and more pernicious cost is the distortion which rising prices introduce into economic behavior. It is the latter which has caused consumer borrowing to rise to unprecedented levels, savings to decline, and productivity to fall. The current preoccupation with the short term portends serious economic difficulties for the future.

The deeply rooted pessimism about inflation and the concomitant changes in behavior have complicated the already difficult task of combating inflation. The appropriate anti-inflation policy must not only reduce the rate of inflation but must also counter the bias against longer term considerations and economic growth.

MONETARY AND FISCAL POLICIES

The approach to our economic ills should be two pronged. Monetary policy should be directed at restricting the growth in nominal gross national product (GNP). Federal Reserve efforts to slow the growth in money supply, will, with a stable velocity of money, restrict the growth in either prices, output, or some combination of the two.

Fiscal policy should be used to promote the expansion of output or real GNP. A combination of federal spending cuts, tax reductions, and a budget surplus would restore both the incentives and the capacity of the private sector to invest and produce. Large reductions in spending, with the resulting surplus, would relieve the Federal Reserve of the burden of financing federal

deficits without squeezing the private sector out of the money markets.

Given Federal Reserve Board Chairman Paul Volcker's avowed monetary course, an appropriate FY 1981 budget would limit federal outlays to $595.0 billion and revenues to $597.6 billion. The fiscal plan would include a budget surplus of $2.6 billion and a calendar year tax cut of $31 billion, to be divided between permanent indexation of individual income tax rates, accelerated depreciation, a more propitious treatment of savings, and repeal of President Carter's oil import fee.

Table 1
Fiscal Year 1981 Comparisons

	Carter Administration	House Budget Committee	Senate Budget Committee	Alternative
Revenues	628.0	613.8	623.0	597.6
Outlays	611.5	611.8	612.9	595.0
Surplus	16.5	2.0	10.1	2.6
Tax Cut	-	10.3	-	20.5

TAXES

President Carter's revised budget of March 1980 calls for federal revenues of $628.0 billion with no tax cut (Table 1). The House and Senate Budget Committees have reported out budget resolutions with revenues of $613.8 billion and $623 billion, respectively. In the House version, the $10.3 billion in oil import fee revenues would be set aside for a productivity-enhancing tax cut. In addition, the House Republicans plan to offer an alternative budget with a calendar year tax cut of $32 billion.

It should be noted that in none of the three proposals are federal revenues reduced below the level which would accrue, assuming no legislative tax changes. All three versions assume that additional revenues ranging from $6 to $8 billion will result from withholding taxes on interest and cash management policies.

Revenues for FY 1981 should be $597.6 billion, $9 billion below current service levels. This calculation is based on enactment of $10.2 billion in fiscal year 1981 cuts (Table 2), repeal of the oil import fee, and the appropriate rejection of tax speed-up measures. The intent is to place as much of the total aggregate demand in the hands of the private sector as is possible.

Table 2
Fiscal Year 1981 Revenues
(billions of dollars)

HOUSE BUDGET COMMITTEE REVENUES			624.1
minus - cash management	2.6		
minus - withholding on interest	3.4	6.0	
minus - repeal of oil import fee	10.3	10.3	607.8
minus - FY 1981 tax cuts (with 30% feedback)			
Indexation	7.0		
10-5-3	1.2		
Savings	2.0	10.2	597.6

Indexation

Permanent indexation of individual income tax rates for inflation is a matter of both equity and efficiency. There is no support for the notion that, as inflation rises, the federal government makes more efficient use of expenditures than the taxpayer. Yet during an inflationary episode the unindexed tax system effectively increases the real tax burden and shifts resources to the public sector.

The unindexed tax system is inequitable because the effective tax increase has not been subjected to the legislative process. Perhaps more importantly, the shift in resources associated with the present tax system creates inefficiencies. In accepting a level of taxes, consumers balance the value of the private consumption foregone with the value of services provided by the government. The unindexed tax system, by surreptiously shifting resources, reduces the utility a consumer receives from a given level of income.

Unlike an alternative short-term tax cut, such as social security rollback, permanent indexation may contribute to wage demand restraint. Workers attempt to maximize not their nominal income but rather the value of the goods and services which that income will purchase. Aware that the progressive tax system will reduce the power of a pay increase which merely matches the rate of inflation, workers continuously must demand greater wage increases. Indexation, by eliminating the tax system's real bite out of strictly nominal income increases, should permit workers to maintain the real value of their incomes with smaller wage increases. The Congressional Budget Office has calculated that the FY 1981 revenue loss attributable to indexation would be $10 billion.

Accelerated Depreciation

Just as "bracket creep" has increased the effective individual income tax rates, the unindexed depreciation schedule has caused business taxes to rise. Profits, and hence income taxes, are

overstated because the depreciation expenses are based on historical and not replacement costs. Martin Feldstein has calculated that, due to the inflation-induced variance between the two costs, 1977 profits were overstated by $35 billion.

Higher taxes and dividends paid out of overstated profits leave fewer resources available for investment. Slower investment translates into smaller productivity gains, less economic growth, and a deterioration of U.S. competitiveness.

Rather than attempt to index the entire depreciation schedule, a simpler alternative would be to establish an accelerated version. The 10-5-3 principle embodied in the Capital Cost Recovery Act (buildings would be written off in 10 years, tangible property, such as machinery, in 5 years, and investment in automobiles and light duty trucks in 3 years) is one of several alternatives available.

The benefits of accelerated depreciation are appealing (Table 3). Norman B. Ture, Inc., in a study undertaken for the National Association of Manufacturers, has found that the 10-5-3 Capital Recovery System will in 1983 provide an additional 370,000 jobs, expand GNP by $51 billion (in 1979 dollars) and increase gross private domestic investment by $55 billion (in 1979 dollars). The Treasury has estimated the first fiscal year cost of the Capital Cost Recovery Act at $1.7 billion, before feedback.

Table 3
10-5-3 Capital Recovery System
Constant 1979 Dollar Projections

Increase or Decrease (-) In:	1980	1981	1982	1983	1984	1985
Employment (thousands of full-time equivalent employees)	160	230	290	370	450	560
Annual Wage Rate	$130	180	230	290	360	450
Gross National Product (billions)						
Total	$ 21	30	40	51	66	92
Business Sector	17	24	32	41	51	70
Gross Private Domestic Investment (billions)						
Total	$ 11	30	42	55	61	34
Nonresidential	16	35	49	63	76	35
Consumption (billions)	$ 10	(1)	(2)	(4)	5	58
Federal Tax Revenues (billions)						
Net of feedback	$ (2)	(8)	(16)	(25)	(32)	(26)
Initial impact	$ (6)	(11)	(20)	(28)	(35)	(36)

Note: The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year.

Amounts shown in parentheses are decrease from present law in that year, not from the preceding year under the tax change.

Source: Norman B. Ture, Inc., NAM.

Savings

The Capital Cost Recovery Act is designed to provide businesses with the internal resources for investment. External financing though equity or debt can be encouraged through more salutary tax treatment of personal savings.

On a secular scale, personal savings in the United States are substantially below such competitors as Japan or West Germany. This long-term gap is exacerbated by inflation's short-term incentive to shift resources from savings to consumption. Rather than provide for future consumption in the traditional manner, such as savings accounts or share holdings, consumers invest in more exotic and less productive hedges, such as gold or antiques.

To encourage savings, changes in the tax system must increase the rate of return on marginal or additional savings. An exemption on the first $200 or $400 in interest or dividends, although it can certainly be advocated on equity grounds, will not cause anyone to increase the amount of savings beyond that necessary to achieve the entire exemption. Studies have indicated that these particular ceilings will induce little additional savings.

There have been several bills introduced this session designed to increase the marginal rate of return on savings. One proposal, H.R. 6400, introduced by Representatives Clarence J. Brown (R-Ohio) and John Rousselot (R-Calif.) and S. 2242 by Senator William V. Roth (R-Del.), would separate the earned and unearned portions of income and apply the progressive tax rates to each. The top rate on savings income would be reduced from 70 to 50 percent. In addition, individuals with over $10,000 in preference income (other than capital gains) would be ineligible for income splitting.

Under present law, a family of four, with wages of $25,400 and interest and dividend income of $4,400 would face a 32 percent tax against any increase in income. H.R. 6400, by splitting the incomes, would lower the tax liability of any additional savings by one half, to 16 percent. Michael Boskin of Stanford University has found that a one percent increase in the return on savings will prompt an increase in savings of 0.3 to 0.4 percent.[1]

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1. M. J. Boskin, "Taxation, Saving, and the Rate of Interest," Journal of Political Economy, Vol. 86, No. 2, Part 2 (April 1978), pp. S3-S27.

H.R. 6400 could be phased in over several years, with possible first year costs of $2-3 billion.

Oil Import Fee

The House Budget Committee has set aside the $10.3 billion in revenues expected from the oil import fee for a productivity-oriented tax cut. This action, however, would not lower the aggregate tax burden, but merely alter its composition. The proposal would finance the lower tax liabilities of the productive sector by assessing a tax against oil and gasoline consumers. A far more efficacious policy would be to match the productivity tax cut with a reduction in federal spending.

SURPLUS

The FY 1981 surplus of $2.6 billion does not represent a reduction in aggregate demand, but rather a shift in resources toward the credit market. Instead of meeting the cash demands created by expiring federal debt through the issuance of more debt, a surplus would permit a net debt retirement. In the credit markets this would make more resources available to the private sector.

SPENDING

Federal spending should be reduced as FY 1981 revenues are reduced for two reasons. One, a failure to cut spending will lead to a deficit. This would place great pressure on the Federal Reserve to abandon its tight money policy and prevent the government from crowding the private sector out of the capital markets, thereby offsetting the investment inducements offered by the tax cuts. Secondly, since the tax measures designed to stimulate investment and productivity will not immediately result in sufficient supply increases, the tax reduction unaccompanied by a cut in federal spending will create excess demand and even greater inflationary pressures.

The House Budget Committee outlined $16.5 billion in budget cuts in its reported resolution. This study adds another $21.9 billion. [See Appendix.] Although it is difficult to believe that Congress will, in one year, cut spending by $38.4 billion or even $16.5 billion, the purpose of this exercise is to show what could be done.

To maximize the economic effects, the spending cuts should reduce many of the transfer programs now in effect. The proliferation and expansion of these programs has often created disincentives to employment. Of the $21.9 billion in outlays reductions recommended, roughly $10 billion is drawn from transfer programs.

Eugene J. McAllister
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APPENDIX

House Budget Committee FY 1981 Outlays	611.8
Gramm-Holt Amendment (Increase Defense Spending)	5.1
(Offsetting outlay cuts are included in reductions below.)	
	616.9
Reductions	21.9
Transfers	
Tax Unemployment Benefits	3.1
Change in Trigger for Unemployment Insurance Extended Benefits	1.0
Modification of Trade Adjustment Assistance	0.150
Modification in Federal Compensation Practices	0.49
Modification of Index for Federal Programs (Including Social Security)	3.5
Overlap between Food Stamps & School Lunches	1.18
Eliminate Certain G.I. Bill Benefits	0.70
User Charges	
Coast Guard User Charges	.40*
Corps of Engineers User Charges	.98
Airports and Airways	.91
Large Airports	.10
Fees to Cover Costs of Food Product Inspections	.31
Reimbursement of Veterans Administration	.20
Reduce Subsidies for Maritime Industry	.13
Elimination of Solar Demonstrations	.85
Fees for Outpatient Visits to Military Hospitals	.076
Eliminate Subsidies to U.S. Postal Service	.778*
Federal Employment	
Reform Wage Board Pay System	.26
End Dual Federal Pay for Reservists	.035
Reduce Summer Youth Employment	.264
Eliminate Davis-Bacon	.750
Selective Cuts	
Restructure College Student Loan Program	.40
Eliminate Impact Aid	.25
Limiting Federal Highway Aid	.20*
Terminate Legal Services Corporation	.25
Reduce Support for Health Professions Progams	.05
Reduce Cultural and Recreational Support	.326
Excessive Department Overhead (Travel, Equipment, etc.)	3.9
17.5% Cut in 17 Major Regulatory Agencies	.47
FY 1981 Outlays	595.0

*Cuts in excess of House Budget Committee actions.