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FISCAL POLICY AND INFLATION

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Chronic inflation has been the outstanding feature of the United States economy for more than a decade. It is our foremost economic ill as we approach the 1980s. Inflation has decimated consumer purchasing power, inhibited business investment, and weakened our export competitiveness.

Since last December, consumer prices have risen at an annual rate of 13½ percent, a sharp acceleration from the 9 percent of 1978, and almost double the 1977 inflation rate.

Earlier this year, a major element in inflation was the rise in food prices. Bad weather and strikes pushed the food component of the Consumer Price Index to a 20 percent annual rate of increase. But increasingly inflation has come from rising energy prices.

In January and February of this year, some 30 percent of the increase in consumer prices resulted from the rise in food prices. Only 10 percent was attributable to increased energy costs. By May, the proportions were exactly reversed. Since the beginning of 1979, energy product prices at retail have gone up at about a 40 percent annual rate. This is more than three times faster than the rest of the items in the Consumer Price Index.

This year's inflation has stemmed in large degree from forces not directly related to current levels of demand, but rather from those forces which were unpredictable and over which we had little if any control.

The Development of Chronic Inflation

Let's look away from the present situation to the beginnings of our era of chronic inflation. Beginning in the mid-sixties, that initial episode of inflation fit the traditional definition of too much money chasing too few goods. In the 1966-68 period, the federal budget was the engine of inflation. Employment, production, capital spending and real incomes all soared—but so did prices. In the Vietnam War era the classic textbook choice of guns or butter was politicized into guns and butter.

Inflation ratcheted up further as the Vietnam War geared down. For the years 1968 through 1978, the U.S. inflation rate averaged just over 6 percent; its lowest point was 4.1 percent in 1972. By way of contrast, for the years 1952 through 1967, inflation averaged 2 percent and, at its worst, was 3.4 percent in 1957. Thus, *every* year since 1968 has had a higher inflation rate than *any* year between 1952 and 1967.

Rapid inflation became a chronic disease for the first time in U.S. history. Then, in 1970, we experienced another first: recession with continuing inflation. So we coined a new term to describe this phenomenon—stagflation.

Throughout this entire period the economics profession has not acquitted itself well at all. During the 1960s many of the contemporary "leaders" of our profession widely applauded the "new era" where a choice between guns and butter was no longer required. We need not be concerned with budget deficits and, if the national public debt burgeoned to heretofore unthinkable proportions, why worry? After all, it is only a debt we owe ourselves. Many of the economics profession, because of overriding social conscience and for other reasons, completely gave themselves over to short-run political expedience. The age of rent-an-economist experienced its greatest growth.

As a result of political expedience reinforced by unsound economic policy advice an inflation psychology has developed. It has now become rooted in the American public's mind.

Most of us readily recognize that the area of our economy which matches our textbook models is small and shrinking. Much of the economic arena is dominated by cost-oriented prices and equity-oriented wages. Most prices are set by sellers whose primary concern is maintaining customers and market share over the long haul. Pricing policies, relying on some standard measure of costs, are set to exceed costs by a percentage mark-up that varies little over the business cycle.

Similarly, the key to wage decisions is, generally, the common long-run interests of workers and employers in maintaining job relationships. This means, among other things, long-term wage contracts with automatic cost-of-living adjustments, even in periods of recession. This trend is heightened by other rigidities that have been built into the American system—the minimum wage, increased job security, etc.

These customer and career relationships that insulate and desensitize wages and prices from the "correcting" forces of excess short run supply and demand have genuine social function and value. But the resulting influence on wages and prices has two effects. When total spending begins to expand rapidly, most of the increase

takes the form of a bonus in output and employment, with little added inflation. On the other hand, when the dollar growth of GNP slows, most of the decline consists of loss of production with little relief from inflation. So inflation is slow starting, but, once in place, is extremely difficult to curb.

As the American public has recognized the pernicious persistence of inflation, they have changed their behavior in ways that have made inflation even more rapid and tenacious. Price and wage decision processes have been adjusted to respond promptly to inflation: wages through the spread of escalator clauses in the major collective bargaining contracts; prices through business adjustments to reflect the growing gap between replacement costs and historical costs—raising prices at shorter intervals, ceasing the practice of taking fixed price orders, etc.

The "acceptable" rate of inflation for policymaking has risen from 1.5 percent in the early 60's to 3 percent in the early 70's. We all must be now wondering what the next plateau will be. Probably every candidate elected to national office in - at least - the last decade has promised to fight inflation. Americans have been told again and again by their leaders that inflation would be curbed.

Instead, it has continued to increase. Not unexpectedly then, this broken promise is just one more—but major—factor in the growing credibility gap between citizens and their elected officials. (There is, coincidentally, just as wide a credibility gap between the general public and economists.)

Is There A Remedy?

Is the chronic disease incurable, or is there a remedy? My answer is: yes, inflation can be brought under control (in fact I believe it *must* be) but it can be accomplished *only* gradually and to accomplish it will require tremendous willpower on the part of the American people and our elected representatives.

The whole psychology of inflation has developed and become endemic over the past decade. To be overcome and reversed a long-time period is necessary. The danger is that the willpower won't be sufficient. Politically powerful groups—labor and business—would have to experience pain to overcome inflation (higher unemployment and declining profit margins may be inevitable and the line on spending must be held) at a time when we are going into a national election year. Will statesmanship prevail over political survivorship? It may be too much to ask.

What tools are available to combat inflation if we can find the will? There are a number of anti-inflationary policies, including fiscal policy, monetary policy, and wage and price policies. One thing these policies have in common: there is no quick and painless cure.

Anti-inflation medicine, whatever the brand-name, works slowly.

I believe the correct prescription must use a mix of all of the above policies but my assignment is to discuss the fiscal policy prescriptions so I will concentrate the rest of my remarks on that area.

Fiscal Policy

Fiscal policy—defined with respect to its role in price stabilization—involves use of the taxation and expenditure powers of the government to effect the level of economic activity. Its propositions are fairly straightforward:

(1) An increase in government expenditures raises the gross national product (GNP). The amount of this increase is determined by the multiplier.

(2) An increase in taxes reduces the GNP. The amount of decrease depends on the multiplier. The tax multiplier, however, is always 1 less than the expenditure multiplier (and, of course, of the opposite sign).

(3) A balanced increase in the level of a budget, with both expenditures and taxes rising by the same amount, changes the level of GNP, normally raising it. Thus it is an important truth that $1 of taxes does not neutralize $1 of expenditures. So a balanced budget at a higher level can stimulate economic activity.

Fiscal policy measures can be either automatic or discretionary. Automatic fiscal stabilizers are those which are built into our tax and expenditure programs. As GNP falls, incomes and sales decline, automatically cutting government revenues. The reduction in revenues is greater than the decline in income and sales, due to graduated tax rates. If GNP rises, the opposite effect occurs. Tax receipts are greater than the increase in GNP. Some categories of expenditures, particularly unemployment and welfare programs, automatically increase in response to a decline in GNP. Thus a decline in GNP pushes the budget toward deficit, a rise in GNP pushes it toward surplus. As a rule of thumb, for every additional billion dollars of GNP, the federal budget gains about $300 million of additional surplus or reduced deficit.

These automatic stabilizers serve as our strongest insurance against another major depression. But due to rigidities which have been built into our system, the automatic stabilizers do not operate as effectively against inflation.

The level of economic activity can also be influenced by discretionary fiscal policies, such as new taxes, changes in tax rates and changes in levels of government expenditure and programs. Discretionary stabilizers change the relationship between the government budget and levels of GNP.

The absolute size of budget surplus or deficit cannot be taken as an indicator of its restrictive or stimulative effect, since this absolute size is a result of both movements in the economy and of deliberate fiscal policy. To separate the two effects we have invented the concept of the full employment budget (FEBS). Usually the term "full employment budget surplus (FEBS)" is used for its obvious political appeal. There is no particular other reason for a surplus at full employment.

The FEBS concept, then, is an estimate of what the federal budget position would be if the economy were operating at its full potential. To relate this concept to the present situation, the Congressional Budget Office estimates the following FEBS position, based on the fiscal 1979 budget as passed by the Congress last fall:

Fiscal Year	1977	1978	1979	1980
		(Billions)		
FEB Surplus (+) or Deficit (—)	—10.3	—11.2	1.5	18.9

According to these estimates we are currently passing from a stimulative budget phase into a restrictive phase with 1979 essentially impact neutral if fiscal policies in effect at the beginning of this year are not changed. These policies include (1) the increases in social security tax rates in January 1979 and in the social security tax base in both 1979 and 1980 as well as (2) the income tax reductions made by the Revenue Act of 1978, effective in January of this year. Possibly, then, the Administration is on the correct course and its policies should be supported and given the chance to work.

To support the present set of policies will require, on the part of both the Congress and the American people, a restraint and an elevating of the public good above private self-interest not evident in recent years. There is already considerable clamor in the Congress, in the press, in powerful vested interest groups (both the "Chryslers" and the labor unions) and from some economists for measures to either stimulate the economy (anti-recessionary measures such as tax cuts and increased spending) or to insulate the economy from inflation through various indexation schemes.

A Washington Post editorial of last week deplored the idea that recession might be viewed as a remedy for inflation. "There emerges a certain danger that many Americans—including those in high office who make economic policy—will come to think of recessions, not as failures, but as remedies," read the editorial. It went on to point out the severe cost in suffering exacted by unemployment.

That is one of the major problems: inflation exacts its severe costs as well but they are more hidden and affect less organized constituencies and are therefore less popular to write about. The Administration and the Democratic Congressional leadership deserve applause for holding the line so far. We can only wonder how long they will hold out.

The Rule vs. Authority Debate

Most public finance students agree that fiscal policy can effectively influence the level of economic activity toward price stability. There is, however, considerable debate over whether stabilization policy should rely on automatic stabilizers alone (Rule) or should automatic stabilizers be supplemented by discretionary measures (Authority)?

Rule advocates reject discretionary measures as destabilizing because of lags. The extreme of this view is advanced by Milton Friedman who advocates a completely automatic monetary mechanism for achieving price stability.

Authority proponents contend that automatic stabilizers alone cannot do the job, or at least operate too slowly. As (1) our understanding of macroeconomic relationships and (2) our ability to forecast trends improves, it is foolish (according to this view) not to rely more heavily on discretionary policy when—and where—indicated.

Discretionary fiscal policy measures include variation in the level of public spending and changes in both tax rates and tax structure. It is true, as the rule advocates charge, that all are subject to inevitable lags.

These lags are perhaps the greatest obstacle to the effective use of discretionary fiscal policies. First there is the recognition lag, the several months that pass before the "experts" and analysts can agree that inflation exists. (Obviously we've passed this point). The decision lag follows, the months during which the President and his advisers decide what to do, the period of consideration by the Congress and the additional months before the program or tax changes actually become effective.

Finally there is the effectiveness lag, the period before the full economic impact of the measure takes place. A fiscal policy measure may never be effective if it is viewed as a temporary measure by the public and its impact can be avoided. The income tax surcharge passed by the Johnson administration in 1968 was never effective in dampening excess demand at that time. The primary reason for this lack of effectiveness was that the tax was widely publicized as a temporary measure. The taxpayers believed their government, paid the tax surcharge out of savings or borrowings, and continued to spend at high levels.

One solution to the inescapable problem of lags would be to rely upon automatic stabilizers plus what is termed "formula flexibility." Formula flexibility would index fiscal policy changes to some reliable—and current—indicator of economic activity. Changes in GNP, inventory levels, level of total investment or the consumer price index are possibilities.

The unemployment rate would be a poor choice because of the time it takes firms to hire or lay-off workers. The idea here is that changes in key indicators would automatically trigger a prescribed fiscal policy change, e.g., tax rates would rise in inflationary periods.

Distributional Impacts

All of us are concerned over the distribution of the pain of fighting inflation. As a restraint on private spending Paul Samuelson recently proposed a "modest" increase in taxes on incomes over $30,000 which "would avoid the dangerous and discriminating uncertainties of monetary policy as well as the effect of budget cuts on the poor." Professor Samuelson indicated that this action would affect fewer than 5 million taxpayers while bringing a measure of restraint to bear on recipients of between 1/4 and 1/5 of all taxable income.

Pointing out that the Administration had warned Congress against tampering with increases in Social Security taxes (which fall heaviest on incomes below $30,000) because of the need to limit demand, he felt that President Carter could hardly refuse to accept a similar increase for the same purpose on top incomes.

On the other hand, the President had proposed to cut back on Comprehensive Employment and Training Act (CETA) Programs, hold down federal employee pay increases to 5.5 percent, reduce federal payments to medicare and medicaid recipients and reduce federal payments to the total Land-Grant university system—extension, high education and experiment stations (what was our response to this one?).

More recently Congressman Al Ullman and Senator Russell Long have proposed a value-added tax (VAT) to shift the distribution of tax burdens in somewhat the same direction as Samuelson has proposed. At a minimum the proposed VAT would replace the payroll tax increases scheduled for a big jump in 1981. Payroll Tax increases would impact the greatest on low and mid-income salaried workers. They would be replaced by VAT as a tax on all consumption (food might be exempted to lessen the impact on the poor).

The VAT proposal might also be extended to replace the corporate income tax. The corporate income tax is probably borne mainly by consumers although the evidence is not conclusive. The VAT would be totally passed on to consumers.

I have mentioned these proposals as current, viable discretionary fiscal policy proposals primarily because I know you will have strong feelings about some or all of their features. They are not intended as a comprehensive listing of current proposals nor do I necessarily endorse any of them as *the* fiscal policy presciption for our inflation problems. However, they illustrate the primary point I want to

make. Do *you* believe inflation is a serious enough problem that *you* are willing to hurt for a while to overcome it?

Summary

Chronic inflation did not become endemic in U.S. society overnight. It grew out of the mistaken belief that, in the beginning, we could have our guns without giving up our butter and, more recently, that mortgaging future generations is preferable to suffering short-run pains of recession.

We have become a "fast (temporary) relief" society and there are clearly no such answers to our inflation problems. An inflation psychology and major structural changes have come about in the U.S. society. These must be overcome if we are to do anything about chronic inflation. They will require time to overcome, and will not be overcome without strong leadership and a strong commitment from all of us.

I have not attempted to propose a specific fiscal policy prescription for inflation but instead have tried to give an overview of how fiscal policy works in affecting the level of economic activity.

There are numerous fiscal policy proposals in addition to the ones I have mentioned, but I believe the record indicates that present fiscal policies are just now moving us into an inflation-fighting posture. We can, and should, stand ready to provide targeted relief to the poor and the unemployed during the inevitable recessionary period. But that relief must not provide a general economic stimulus.

I am one who believes that the only ultimate remedy for inflation is recession. Because we have allowed conditions to become so bad we must not expect to correct the economy overnight. I wish I could end on a more positive note but maybe the failure to admit that some medicine must taste bad is what got us into this mess.