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UNITED STATES DEPARTMENT OF AGRICULTURE
Bureau of Agricultural Economics

FEDERAL FISCAL POLICY

Address by Roy Blough, Council of Economic Advisers, at 26th Annual Agricultural Outlook Conference, Washington, D. C., October 30, 1950

The outlook for Federal fiscal policy has been drastically changed by the expansion of the defense program following the Korean attack. Additional appropriations and authorizations for defense and related purposes were approved by Congress in the amount of about 17 billion dollars. The rate of defense spending is expected to roughly double between June 1950 and June 1951. How much the program will be still further enlarged is for the future to disclose. Our thinking should be adjusted to the possibility that such enlargement may be very considerable.

Tax action also was taken by Congress in the recent session. A tax bill which passed the House in June, with the major purpose of reducing excise tax rates, was completely overhauled in the Senate and emerged finally as an act which made no excise tax reductions but increased individual and corporate income taxes by an annual estimated amount of about 4.7 billion dollars. The corporate normal and surtax rate was set at 45 percent for income in excess of 25 thousand dollars, the highest corporate taxes ever imposed except as wartime excess profits taxes, and individual income tax rates in each bracket were raised to within 3 percentage points of the highest rates prevailing during World War II. All responsible leaders are talking in terms of a much larger additional tax increase on top of those already imposed. The Congress directed its taxing committees to submit bills providing for an excess profits tax when Congress reconvenes.

The goal of Federal fiscal activity in the defense program is to contribute to national security and welfare in its fullest sense. The increase of defense expenditures is an instrument by which the economic resources of the country are directed to producing for defense purposes rather than for civilian purposes. In the process, powerful inflationary pressures arise. The problem now faces us, how to stabilize an economy subject to these inflationary pressures--how to dissipate the pressures harmlessly or, at least, prevent them from damaging the economy.

The economic effects of military expenditures are not a new problem. Throughout the postwar period we have had a defense program which, to prewar eyes, would have looked tremendous. And during the war, of course, we had a defense program enlarged to maximum level. Not since 1939 has either the Federal budget or the national economy been free of the influence of heavy current military expenditures.

The economic effects of a military program depend on its size, the speed of its growth, and the attitudes of the public. Size is important because it determines what proportion of the economic power of the Nation must be devoted to the defense effort. The speed at which the program is executed is important

because speed affects the rigor of the economic adjustments which must be made. A slow rate of growth in the defense program might be matched by the increase in the total productivity of the economy, so that no general cuts would be required in supplies to civilians, while a very rapid rate of rearming would necessitate sudden adjustments and thereby require not only civilian sacrifices but direct and rigid controls. Public attitudes are important because no method of solving the problems of a defense economy can be successful without a large measure of public cooperation. Here is a matter on which all of us can help. During the war, the public supported the war effort and the sacrifices and restrictions required by it with great intensity and unanimity. The same patriotic attitude toward the lesser requirements of the defense effort will go far toward making it a success. It is disquieting to see minor inconveniences resulting from steps thus far taken blown up into the appearance of major injustices. Unfortunately, in a long drawn-out defense effort, it is not likely either that attitudes of wartime intensity can be achieved or that they could be maintained if they were achieved. This fact poses a major difficulty for economic policy in the defense period in that some stabilizing measures which would be very useful are likely to be unavailable because the public attitude necessary for their successful application does not exist.

Inflationary pressures are not the only economic problem presented by the enlargement of the defense effort. Another problem is to move quickly toward achieving adequate production of material required for the arming and expansion of military, naval, and air forces, and for civilian defense. In part, this is a problem of stepping up production in plants already engaged in producing military goods. In part, it is a matter of reopening plants which have been kept in reserve since the war. And in part, it is a matter of diverting raw materials, plants, and labor from civilian to military production. Still another economic problem raised by the defense effort is to increase the total productive power of the whole economy. Production and the capacity to produce are basic sources of both military power and a strong civilian economy. The larger the productivity of the economy, the less the impairment of the civilian standard of living required to achieve the necessary defense production. In a full scale war, the military requirements on the one hand and the immediate demands for consumption on the other would so absorb the whole national production that little if any residue would remain to provide new investment and productive growth. With the level of defense expenditure greatly below the levels of full scale war, however, there is opportunity to expand productive power, for example, through increased investment and research.

Fiscal policy can contribute, at least in a minor way, to the solution of these problems of expanding defense production in particular and over-all productive power in general. Government orders and expenditures put the industrial machine to work on defense production. Taxation can furnish the money, which is obviously important, although a lack of tax revenue would not likely stand in the way of spending for defense. Accelerated depreciation can serve a useful purpose in facilitating necessary plant expansion, but its inequities are such that it needs to be used carefully and sparingly. The growth of the economy in general can be aided in this period through a tax policy that avoids repressing economic incentives, and encourages investment. However, increases in investment, while they enlarge future supplies, are made at the expense of current consumption, so that taxes which encourage investment must also discourage consumption if inflationary pressures are to be diminished. This may raise acute problems if consumers

generally press for a high and rising level of consumption, and are unwilling to have it reduced. This brings us back to the problem of maintaining a stable economy in the face of strong inflationary pressures. It is in dealing with this problem that fiscal policy can make a major contribution.

Maintaining a stable economy, particularly price stability, is an immediately urgent and immensely difficult task. The problem is essentially one of maintaining a balance between civilian supply and civilian demand. Civilian supply of some commodities will certainly have to be restricted, for example, commodities made of copper, aluminum, steel, rubber, and so on. Civilian supply in general also may have to be reduced if the increased requirements of defense production exceed the rate of growth of the productive power of the economy. Thus, despite total increases in production, the civilian supply cannot be expected to show much increase, and is likely to show decreases.

Civilian demand on the other hand may be expected to increase. Each dollar of increased production is reflected in a dollar of increased income which, in the absence of preventive measures, is available for spending. Moreover, if consumers expect shortages or rising prices, they may seek to use their savings as a source of spending power, and to borrow for the purpose of buying durable consumer goods and housing. Businessmen, anticipating the increase in governmental and private buying, seek to expand their inventories and enlarge their facilities. All of these elements combined point to demands for civilian goods and services substantially in excess of supply. In the absence of preventive steps, the result would inevitably be price inflation. It is the kind of price rise that would likely become a price spiral, since higher prices would lead to higher wage demands and larger incomes generally, which, in turn, would lead to still further demand, higher prices, and so on. There is evidence that this process has already started.

One of the effects of inflation is to serve as a substitute for taxation. The manner in which inflation distributes burdens among the population has sometimes been compared favorably to the distribution of burdens by certain forms of taxation. There is this important difference. Taxes can be reduced when the need for them declines. But once the price and cost structure has become integrated at a higher price level, any effort to achieve a substantially lower price level is likely to result in unemployment and depression, causing greater social losses than the social gains which lower prices would confer. The only way to cure an inflation is to prevent it.

But why should we be afraid of inflation? Does it not increase our incomes? The increase is purely illusory for the Nation as a whole and the redistribution of wealth and income that results from inflation is economically undesirable and may be socially dangerous. Inflationary price rises would impair the relative and absolute economic positions of those persons and institutions which have relatively fixed incomes or own assets of fixed money value. The members of the armed forces, millions of persons living on pensions and insurance, and other millions receiving salaries and wages that move slowly would be particularly hurt. Educational and charitable organizations would face a discouraging exaggeration of the tremendous problems which wartime and postwar inflation have placed upon them. The distortion of incomes caused by inflation would channel production into unusual and unsustainable patterns, thus sowing the seeds for later depression. The money cost of the defense effort would rise. Public morale would be deeply shaken by the shock of a declining value of money. There would be danger that eventually--fortunately, in other countries it has usually been long delayed--there might be a failure of public confidence in the future of the dollar, with disastrous

consequences. Any large or continuing rise of prices would be a major blow, especially coming so soon on the heels of the price increases during and after World War II.

It is imperative, therefore, that there be the strongest possible resolve within the executive branch of the Government, in the Congress, and by the public that extensive inflationary price rises shall not happen again. There must be better understanding of why they happened before. And there must be a willingness for business, agriculture, and labor to see the rosy outlook of rising money incomes fade out into the grimmer picture of hard realities.

The increase of total production is often proposed as an important method of preventing inflationary price rises, but it is only a partial solution. If production increases because more workers are employed or put in longer hours, they receive larger incomes as do the businessmen and suppliers of raw materials. These increased incomes create greater consumer and business demand. But the increase in supply, generally speaking, is required for defense and is not available to fulfill civilian demands. Thus, inflationary pressures continue, despite larger production

Aside from expanding production, there are three general methods of forestalling inflationary price rises. The first is taxation, which takes money away from people, thus decreasing their ability and willingness to buy more than exists to be bought. Taxation is essential to the continued success of all other methods of preventing inflationary price rises. The second method is to prevent current incomes, past savings, and newly created credit from being spent. Controls on credit help to achieve this result. Allocations and rationing may also be used in appropriate circumstances. It is very important also to persuade the people that it is in their interest and the public interest to save more and spend less. But forestalling inflationary price rises through prevention of spending presents a threat of future inflation when the barriers to spending are lowered.

The third method of forestalling inflation is to prevent incomes from rising, thus preventing an increase in demand. This function is performed directly by price controls, including wage controls, and indirectly by all other methods which prevent price increases. Increases in the prices of products and the factors of production are increases in the incomes of the sellers. If and when other methods fail, direct controls of the prices may be used to prevent incomes from rising. In the process, of course, market forces are interfered with and damage may be done to the functioning of the economic structure, unless at the same time the suppressed demand is relaxed by taxation or other measures. Still, it must be recognized that direct price controls have worked in the past, and are part of the kit of tools that must be kept ready at hand in case other methods do not succeed.

It should be stressed that none of the methods of forestalling inflation creates the burden of the defense program. That burden rises from the requirement that resources and manpower be withdrawn from the production of civilian goods and services at the same time that money incomes are being enlarged by increases in total production.

Let us return to the proposition that tax increases are the basic foundation of any program for forestalling inflationary price rises. To hold to this view, it is of course, necessary first to accept the economic belief that taxation is an effective anti-inflationary measure. During the last war, it was maintained by many people, including some members of Congress, that the appropriate way to fight

inflation was by price controls and that the function of taxes was the narrow one of raising revenue. The recent quick reaction of the public in demanding general price controls at the outset of the Korean crisis may reflect a continuation of that view. We may recall also that in the controversy over tax reduction in 1947 and 1948, some members of Congress maintained that taxation was inflationary rather than deflationary. Yet, if there are any doctrines that economists universally believe, one of them is surely that two basic remedies for inflation are reductions in Government expenditures and increases in taxes.

Of course, we should make every effort to reduce Government expenditures. There is no excuse for inefficiency in Government at any time. Efficiently run Government programs may be worth what they cost, more than they cost, or less than they cost. The last, of course, should not be undertaken. But determining the worth of governmental programs to various segments of the public is an economic and even a philosophical problem of no small dimensions. It will be agreed, however, that some programs which are clearly worthwhile in a period of relaxed peace may have to give way when the pressure on the economy of defense requirements rises as it is rising today. I do not recall knowing anyone who does not recognize this effect of changing times on the importance of governmental programs. Of course, opinions differ about how important certain programs are.

Substantial reductions in nondefense expenditures have already been made. I am sure that anything you can do to further reduce expenditures on Government programs that have a low priority will be more widely appreciated in Washington than you may believe. Government programs are not spawned by a few willful men. They result from pressures by large groups of the public. Our political system is not well adapted to resisting such pressures. The effort to reduce Government expenditures which do not promote the productive power and public morale of a defense economy is laudable, but we should not expect too much to come from it.

Heavy reliance in fighting inflation must be placed on tax increases. Let me emphasize again that an increase of taxes in a time like this does not create any new economic burdens. The defense program has created them already. All that the higher taxes do is to distribute the financial burden at once and finally. Taxation is superior to other methods of preventing inflationary price rises in important respects. It does not interfere with the operation of market forces. It does not present the threat of future inflation. It distributes the financial burden at the same time the economic burden must inevitably be borne. It protects the men and women of the armed forces from the ironic unfairness of fighting a war and coming home to pay for it too. Taxation is the normal method of providing funds for Government expenditures. In the absence of very good reasons, the total cost of the defense program should be paid as we go, out of current revenue.

The general acceptance today of paying for the defense effort through current taxes represents a great advance in public sentiment over that existing ten years ago. In 1940 a very small defense program was financed by borrowing which was to be repaid over a five-year period. I hope the advance represents a permanent gain. Almost everyone is now for pay-as-you-go. The test is whether you or I will still be for pay-as-you-go when we see the taxes and rates that will be required to achieve that result. As I recall, when the Revenue Bill of 1943 was under consideration, not a single important organization of businessmen, farmers, or workers was in favor of higher taxes, despite the fact that in the fiscal year that had just ended, budget receipts were less than 30 percent of expenditures. The danger is that once again when the American public sees what is involved in paying for the

defense program through taxes, there are influential groups which will discover that there are other, "better" ways of financing the defense effort, i.e., borrowing.

Even noninflationary borrowing does not postpone the total economic burden; it postpones only the allocation of the financial burden. Postponement of the financial burden means that in the future either higher taxes or inflation will extract the price which was avoided during the defense period. Borrowing is appropriate in a short and intense period of all-out effort. But for the long pull at a level considerably less than that of all-out war, there seems little sense in trying to postpone the financial burden to still a longer run. Psychologically there is some value in the mirage of postponement; when taxes pass some very high point, it may be necessary to resort to this mirage. But we should not use it unless it becomes imperative. Putting off the financial load until later eases the present pain, and we live forever hopeful that somehow someone else will bear the taxes later. But we, the public as a whole, will either bear the taxes or bear the inflation. It is better to bite the bullet now, while the threat is upon us. The long pull, whether it lasts five years or a generation, is not the kind of time to be piling up even a noninflationary type of debt.

Pay-as-you-go does not mean simply pay some time within a year or two or three. It means literally collecting the money not later than the time it is spent. Indeed, since inflationary pressures are running ahead of increased expenditures, the use of taxes to fight inflation calls for the largest practicable tax increase at the earliest possible moment. If surpluses of revenue are thereby achieved, so much the better in fighting inflation. The tax law which was recently passed is an excellent start. If taxation is to achieve its maximum usefulness in fighting inflation, this law must be followed up with other very large tax increases as soon as Congress is in a position to consider them.

If taxation is to perform successfully its anti-inflationary mission, tax increases must not give rise to compensatory increases in the incomes of those on whom the tax is intended to rest. The purpose of a tax program is to distribute the burden of taxes among the various taxpayers in a fair and economically sound manner. If any major economic group is able to escape the burden of the tax by securing a larger income, the intended burden distribution will be frustrated, and the tax does not achieve its anti-inflationary goal, since it does not reduce spending. It is then necessary to increase the burdens and reduce the spending of other economic groups. This is unfair and necessitates an unnecessarily large total volume of taxation, intensifying all the problems which high taxes produce.

The principle that tax increases must be absorbed by the persons who are intended to bear them has a direct bearing in applying wage contracts where wage increases are based on increases in the cost of living. Following this principle would mean that tax increases which apply directly to the worker would not be considered in wage negotiations and that the effects of tax increases on prices would be excluded in computing the cost of living. If this principle were not followed, these groups of workers would be placed in a peculiarly favored position being protected against both taxes and inflation, while other groups in the community would be obliged to bear an increased part of the burden, in either taxes or inflation.

This principle that tax increases should not result in compensatory income increases also has a bearing on agriculture. In computing parity prices, increases

in the prices of things which the farmer buys would not, under this principle, include any price increases which reflected tax increases. Otherwise, the parity price formula would operate to protect farmers against tax increases imposed in the form of sales, excise, or other shifted taxes.

Under this principle also, prices would not be raised by either private or public action because of increases in corporate income or profits taxes. Otherwise, business would escape the load intended for it and other groups would be unfairly burdened. Similarly, there are implications of this principle with respect to the excess profits tax. Measurements of excess profits would be based on profits before taxes rather than on profits after taxes, at least so far as tax increases are concerned.

One of the most puzzling problems of fiscal policy in the defense effort is how to promote equality of sacrifice in the face of the common emergency and at the same time give sufficient incentives to get the job done. As long as members of our armed forces are in personal danger or are being drafted from families and professions, emphasis must be strong on promoting equality of sacrifice, although obviously this cannot be completely achieved. There must be no great private gain from the defense effort, if the public generally is to be expected to bear the restrictions and burdens placed upon it. However, in our economy primary reliance for production must be on willing personal effort carried on without fear of the snooper or the threat of court martial. It has proved difficult through patriotism alone and without extra compensation to sustain the extra effort and extra efficiency that are required to get the job done. And to those who are not themselves required to put forth an extra effort, any extra reward received by others may appear to be the direct opposite of equal sacrifice. The problem is particularly difficult in the distribution of the tax burden. I do not know if there is a solution, but mutual forbearance and understanding will help.

The problem of how to prevent inflation in the defense economy is largely one of unpleasant alternatives. They are, of course, not altogether alternatives. It will undoubtedly be necessary to use in some degree all or nearly all the methods available to fight inflation. It is important to understand that the higher the taxes are raised, the less necessary it is to resort to the other, less desirable, methods of preventing inflation--up to the point where taxes exceed their economic limits. There is no royal road for bringing the economy safely through the strains of the defense program. It will take all of the understanding that we have, all of the self-restraint we have, and a great deal of willingness to accept onerous deprivations and burdens if we are to avoid damaging inflation.

But Government by the people will not work unless we have a responsible public which puts the National interest ahead of private interest. If important segments of the American public are going to assume that they must be protected against sacrifice, if groups with large economic power insist that their incomes after taxes must be kept sufficiently high to maintain their accustomed habits of expenditure, then there is no remedy except to impose compulsory direct controls. I am confident that once the farmers, the workers, the businessmen, and other major groups in the American economy see the dangers of selfishness and understand the nature of the economic problems of the defense economy, these problems will prove to be reasonably solvable.