An Uncertain Outcome

Brief Statement prepared for the
Senate Finance Committee
Wednesday, February 24, 1982

by Allan H. Meltzer

The administration's budget policy and Federal Reserve monetary policy have at least one common feature. Both increase uncertainty about the future and thereby make planning for the future difficult. The reasons are very different, however.

Federal Reserve Policy

The main problems with Federal Reserve policy arise because, despite statements full of good intentions and worthy goals, the Federal Reserve does not make any of the changes that would improve monetary control and lower interest rates. No one can have any confidence in Federal Reserve statements that reaffirm their commitment to slower money growth and lower inflation because, more often than not, the Federal Reserve has not honored previous commitments. Currently, as in the recent past, a wide gulf separates Federal Reserve statements and Federal Reserve actions. Table 2 shows the discrepancy between Federal Reserve announcements and achievements for the six years in which they have announced targets for money growth.

Table 1

Money Growth 1975-81

Year Ending in 4th Quarter	Percent Growth: Target Announced by Federal Reserve	Target Mid-point	Actual	Error
1976 (M-1)	4.5 - 7.5%	6.0%	5.8%	-0.2%
1977 (M-1)	4.5 - 6.5	5.5	7.9	2.4
1978 (M-1)	4.0 - 6.5	5.2	7.2	1.9
1979 (M-1)	3.0 - 6.0	4.5	5.5	1.0
1980 (M-1B)	4.0 - 6.5	5.2	7.3	2.0
1981 (M-1B)	6.0 - 8.5	7.2	5.0	-2.2
1982 (M-1)	2.5 - 5.5	4.0		

In four of the most recent six years, the Federal Reserve failed to keep money growth within the pre-announced target band. Since 1979, the Federal Reserve claims to be more concerned about money growth, and gives greater emphasis to money growth in its statements, but monetary control has worsened. Annual errors are larger, and short-term variability has increased. Better procedures, endorsed by virtually all monetary economists, including Federal Reserve staff, are available, but they have not been adopted.

Recent Federal Reserve policy is more variable than in preceding years. Sudden shifts in policy have been a principal cause of two recessions experienced in the last two years. The surge in money growth during December and January will, if continued, reverse the progress made toward lower inflation. An attempt by the Federal Reserve to remain within the announced target band for the year will require slow growth for the rest of 1982 and produce a pattern roughly similar to the 1981 pattern. It seems likely that the Federal Reserve will neither maintain the high rate of increase of the most recent quarter nor return to its announced growth path.

What will the Federal Reserve do in 1982? Neither you, nor I, know. They do not seem to know. Why should anyone expect homebuilders, farmers, investors or consumers to act boldly or confidently in the face of this pervasive uncertainty about money growth, inflation, interest rates and the prospects for sustained recovery that is, in part, a result of Federal Reserve policy? How can anyone be confident that interest rates will rise or fall under current conditions? Is there any reason to wonder why published forecasts of interest rates now cover the widest spectrum in memory?

These questions reflect the uncertainty we all experience. The response of the Congress to the uncertainty is puzzling. The Federal Reserve is a creature of the Congress, but the Congress does not undertake to improve the Federal Reserve's performance despite repeated failures to meet its targets. We are in danger of losing this current opportunity to have less inflationary, more stabilizing policies.

Budget Policy

The administration's budgets for fiscal 1983 and future years, when combined with currently available guesses or estimates about future economic activity and inflation, raise doubts about the internal consistency of the fiscal program and the future stability of the economy. These doubts are of two kinds. One concerns the success of the promising effort to restore productivity growth to its historic path and increase personal incentives by reducing current and future tax rates. The other is the increased probability that the budget deficit will rise at a faster rate than output, thereby reducing real capital formation and generating increasing economic instability with rising real rates of interest, falling productivity and a chain of events that no one can forsee accurately or predict reliably. There is no way to anticipate the full effect of ever-increasing real budget deficits and an ever-increasing share of total saving absorbed by deficit finance. While no one can be confident about the effects of continuously increasing deficits, the effects are unlikely to include any of the paths of stable growth and declining inflation used by CBO, OMB and private forecasters to generate budget data for the next five fiscal years. There is, therefore likely to be an inconsistency between the projections for the economy and for future deficits. The result may be deficits larger than forecast, a decline in real income and standards of living leading to an economic crisis. Or, the economy may continue to limp along the path characterized by low productivity growth, rising real transfer payments and a rising size of government.

There is nothing certain about these outcomes, or any other. We have no prior experience on which to base a reliable judgment because there is no example in which a large economy – the largest economy – ran deficits of this relative magnitude for an indefinite period. There is great uncertainty. Prudence requires that the uncertainty be lessened, promptly.

I want to expand my views on three aspects of the budget problem. These are the degree to which the problem is now manageable, the extent to which the underlying policy program is correct, and the type of action that should be taken to reduce future deficits.

First, I believe the budget problem is manageable. I am less concerned about the deficits for fiscal years 1982 and 1983, that receive so much attention, and more concerned about the stream of deficits that continue – and seem likely to rise relative to our ability to produce output – for the forseeable future and beyond. The near-term deficits raise serious problems for housing and for the merchandise trade balance, but these problems are manageable; the longer-term deficits may not be.

Second, I continue to believe that the administration's policy or program is correct. Reducing the growth of government spending, reducing the share of output spent by government and reducing tax rates is a means of increasing incentives to save, work and invest. The problem is not in the policy conception or design but in its implementation. The proposed reductions in spending are too small relative to the projected reductions in tax collections. To achieve the promised gains from tax reduction requires additional cuts in the growth of spending. The principal reason is that current policy does not reduce the share of output spent by government and may, instead, lead to increases in that share.

While the share of output spent by government is a more reliable measure of applicable tax rates than the revenue share, no single measure summarizes the incentive and disincentive effects of government programs. Nevertheless, when the administration proposed the fiscal reform program, and when the Congress adopted Humphrey - Hawkins and the 1981 fiscal program they proposed to reduce the share of output spent by government to 20% of GNP or less. This promise is unfulfilled and is unlikely to be fulfilled. Currently, government spending remains between 23% and 24% of output, and the percentage is not likely to be reduced without further reductions in the growth of spending.

Third, for the United States, at present there are two main ways to use fiscal policy as a tool to increase productivity growth – by increasing the share of output invested in capital and other productive assets – while reducing the deficit. We can, as a nation, decide to reduce the growth of consumer spending, relative to GNP, by raising tax rates on consumer spending. Or, we can reduce the growth of government spending, relative to GNP.

Taxes on spending encourage consumers to save more and spend less. The additional saving finances investment, and the additional taxes reduce the deficit. Raising taxes on consumers forces the current generation of consumers to finance capital accumulation and maintains the size of government.

Reducing the growth of government spending lowers the budget deficit relative to GNP and allows consumer spending to rise. Major reductions in projected spending are difficult to implement quickly. Fortunately, the budget problem does not require substantial reductions in the outlays for fiscal 1982 and 1983. But, action is required this year to reduce spending for fiscal years 1984 and beyond. This is particularly true of military spending, where the distinction between obligational authority and outlays is most relevant, but the distinction is not limited to military spending.

I believe that the better solution is to reduce the growth of spending, not to raise taxes. The main reason is that two oil shocks, inflation and slow productivity growth have left us poorer than we expected to be when many of the income maintenance and transfer programs were adopted or expanded in the past two decades. Consumers' real incomes, after taxes, reflect the slower growth of real income. Most transfer payments do not. Transfer payments have increased in real terms at a faster rate than real income, consumer spending and real wages.

Concluding Comments

Current fiscal and monetary problems pose a challenge to representative government. The problems are easy to state. Solutions are not hard to find. None are easy to implement. None are costless. None can be chosen on technical grounds alone. The problem is political; we must change our policies.

At issue is the ability of representative government to put an end to the current fiscal crisis and the rising instability brought about by destabilizing budget policies and Federal Reserve actions. The alternatives to a change in policy are less attractive. We run the risk of sliding into the combination of immobilism and instability characteristic of modern Italy or of moving to some other less desirable solution that no one can now forsee.