Economic Policy in the Carter Administration

Testimony prepared for the House Budget Committee
Washington, D. C.
March 3, 1977

by

Allan H. Meltzer
Maurice Falk Professor of Economics
and Social Science
Carnegie-Mellon University

Draft
February 1977

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A new administration, a new Congress and a new corps of economic advisers is commonly the occasion to reconsider the strategy for the future, the successes and failures of the past, and the long-term consequences of current actions. Early impressions are subject to revision, in much the same way that economic statistics are revised, and I hope that my early impression of Carter administration policies will be as incorrect as the forecasts of those who found real meaning in the so-called "pause" last fall.

The first signs are disquieting, however, to anyone who believes that the proper goals of policy for the United States are to return to full employment, eliminate inflation, improve efficiency in the use of resources, and increase freedom. These goals cannot be achieved by programs that place one objective -- employment -- above all others or that strive to achieve more employment now and reduce inflation "later." Freedom and efficiency are reduced, and sustained inflation is unaffected by guidelines for price and wage increases. Whether these guidelines are mandatory or whether they are called "voluntary," their principal result is to divert the attention of the public by offering a comic opera for their leisure and a waste of the time of those who enforce controls and those who respond to the enforcers.

Guidelines and controls are not the only restriction on freedom and efficiency. The emergency energy program, the first economic legislation passed this year, is heavy with the suggestion that it is more important to investigate the ownership of natural gas inventories than to encourage efficient production of additional supply. Once again, we have acted in crisis to increase the authority and power of the government over economic activity, exchanging freedom and an efficient solution for some temporary relief from the cold.

Government controls and regulations created a shortage of natural gas and prevented a rational solution to the shortage. The government uses the crisis to justify an increase in its power and authority to allocate supply and coerce suppliers. The fact that the grant of power is temporary justifies neither the grant of authority nor the failure to choose a rational solution.

The administration's fiscal program also developed in disregard of freedom and efficiency. The presumption underlying the program is the simple Keynesian view that neglects all effects on incentives, prices and anticipations. What matters for consumption is the amount consumers receive; what matters for investment is the additional amount consumers spend. Thoughtful investors and consumers who project after tax rates of return before deciding to invest could be encouraged by permanent tax reduction, or in other ways, but they are not. Indeed, they cannot for long be encouraged by the fiscal prospects that we face.

The fiscal program neglects freedom and efficiency, also, by protecting the bureaucracy and future budgets from reductions that would increase the efficiency with which society uses resources and the freedom of individuals to decide on how they wish to spend their incomes. The long-run thrust of the Carter program is to balance the government budget only, if at all, by increasing tax rates through inflation, not by reducing the growth of public outlays or the relative size of government.

In three respects, the fiscal program is a strong reminder of some past policies. First, once again, we are to know the arrogance of fine tuning. Second, we are offered another piece of legislation designed by the Association for the Protection of the Civil Service. Third, we return to the failed policy of "priorities" that promises lower unemployment now and less inflation later but produces instead a temporary gain in employment followed by more inflation and more unemployment later. I propose to discuss the short- and long-term effects of the administration's program in turn and to offer an alternative.

The Short-Term Problem

The fiscal program is based on two errors. One is judgmental; the other is a conceptual error with several facets. Let me dispose of the judgmental issue quickly since it is rapidly becoming clear that the much discussed slowdown in the economy was misinterpreted by Keynesians eager to believe that, because government spending in the third quarter fell below projections, the economy paused.

If we look at the quarterly rates of change of gross national product in 1976, the expansion reaches a peak rate of change in the first quarter, then slows for the rest of the year. The growth of final sales shows exactly the opposite pattern. Rates of change of final sales in dollars of constant purchasing power are lowest in the first quarter and highest at the end of the year. The difference between the two series is entirely the result of business decisions to first build and then reduce inventories.

There is a simple, plausible explanation of the pattern of inventory change. At the beginning of 1976, the belief was widespread that the administration and the Federal Reserve would produce enough stimulus to assist in the election of Gerald Ford. Excessive fiscal or monetary stimulus in election years is part of the pattern known as the political business cycle. Election year 1964 brought a tax cut. Elections in 1968 and 1972 brought a mixture of expansive fiscal and monetary policies. Election year 1976 was widely expected to bring more of the same.

In the first months of 1976, businesses built inventories in anticipation of rapidly rising sales and the higher rates of inflation they expected to follow. By the end of the first quarter, anticipations of another political business cycle were confirmed. The time for stimulus that would benefit the incumbents passed. Vetos of spending programs made the headlines. Inventories were brought into closer relation to sales.

This interpretation of 1976 suggests that additional stimulus is neither required nor desirable. The economy does not require a fiscal program to stimulate spending and create jobs. The weakness of the economy was overstated during the election campaign; current strength is misjudged.

Errors in forecasting are not so rare that we should dwell on them. Two percentage points or more is about the average error in quarterly forecasts of the rate of change of real GNP and the price level in recent years.

The more serious problem arises from the type of action proposed. The fiscal program appears to be based on a belief that economists can achieve more output now without increasing the rate of inflation. This is to be done by timing the injections of stimulus and restraint so as to bring idle resources into use. The critical underlying assumption is that, bottlenecks aside, larger supplies of output can be produced without raising the rate of price change. Even avid proponents of additional stimulus recognize that the stimulus must be reduced when the economy approaches full employment. We have returned to fine tuning.

Instead of general policies that provide relatively clear indications of the thrust to be exerted by government programs, private decision makers face increased uncertainty. To make plans, they must guess at the type of tax structure and the length of time reductions in unemployment insurance taxes or increases in investment tax credits will remain in effect. To estimate future sales, they must guess at the size and duration of the effect of the rebate.

Behind the fiscal package lies the belief that economists can predict the effect of various mixes of stimuli with sufficient accuracy to provide a choice to policymakers. The alternative of providing a more stable fiscal environment is rejected. This, too, is a return to fine tuning. I do not know any evidence to support the belief that economists can predict the short-term aggregate effects of specific tax cuts with sufficient accuracy to justify the policies that are now proposed.

Long-Term Effects

Choice of a one-time rebate instead of general tax reduction is a way of maintaining future tax collections. President Carter has promised a balanced budget for fiscal year 1981, and permanent tax reduction would permit that promise to be kept only if the growth of government falls or the rate of inflation rises. Speculation on whether the administration can achieve a balanced budget for fiscal 1981 generally ignores the effects of inflation. Since the tax system is not indexed, a balanced budget can be achieved by allowing inflation to rise.

In Five Year Budget Projections: Fiscal Years 1978-82, the Congressional Budget Office shows the extent to which inflation is required to balance the budget in 1981 or 1982. Much of their analysis is based on an explicit assumption that the unemployment rate can be brought to 4% by 1982 if real growth is maintained in the neighborhood of 5-1/2% for the next four years. The policy of vigorous expansion adds to inflation so that by 1982, the inflation rate is back to the 1976 level.

Many economists in and out of government regard the projected 4% unemployment rate as achievable only temporarily and at the cost of rising inflation. Several careful studies of the labor force show that after adjustment for demographic changes, the full employment rate of unemployment is now about 5.5% to 6%. The Congressional Budget Office developed a set of projections based on a less vigorous expansion that reduces inflation. On the less vigorous expansion path, unemployment and inflation fall to 5.5% and 4.6% respectively in 1982. All of my estimates start from these budget data.

The presumed expansion produces 10.4% nominal GNP growth in 1977 and 9.8% in 1978. Subsequently, nominal growth is steady at 8.6%, with 4.0% real growth and inflation of 4.6%. No effort is made to reduce inflation after 1979, so inflation raises government revenue by pushing households into higher tax brackets. Moreover, owners of business firms are taxed because depreciation of capital is tied to historic cost. The replacement cost of capital rises with inflation, but depreciation does not, so reported profits are overstated by the difference between replacement cost and the book value of capital. Corporate taxes are increased in this way.

As one of my former students Hai Hong points out, the government continues to collect tax revenues from firms even if inflation ends tomorrow. Of course, owners of capital have taken the loss in the stock market, and new owners of capital intensive firms pay a price that reflects the estimated after tax revenues.

The effects of inflation on tax payers remain in a fully anticipated inflation. To these, we must add the effects of unanticipated inflation. Unanticipated inflation taxes owners nominal wealth. These effects are more frequently discussed by economists, but they are much smaller than the effects of anticipated inflation on tax payments.

The 4.7% inflation assumed by the Congressional Budget Office adds $24 billion to Federal tax revenues in 1978 and transfers $150 billion in 1982. For the five year period 1977-82 the cumulative increase in tax payments from inflation is $408 billion. These sums are obtained using an average marginal tax rate of 25% and the estimated change in real income, obtained from the CBO, to compute the tax revenues that would be collected if inflation ended in 1977.

The $408 billion tax revenue from inflation is 16% of total tax collections in the five year period. The tax revenues from inflation permit the government to balance the budget and to increase the share of GNP collected in taxes. On the CBO assumptions, Federal tax collections as a percentage of GNP increase by more than two percentage points as we move toward full employment in 1982.

An estimate of the contribution of inflation to reducing the budget deficit requires an adjustment of government outlays. Outlays increase with inflation by less than taxes. The response of outlays to inflation computed from CBO projections, is more variable from year to year than the response of taxes, so I used the computed response for each year instead of the average response for the five year period.

The cumulated deficit for the five years 1978 to 1982 is $162 billion at zero rate of inflation and $45 billion on the CBO assumptions. Inflation reduces the budget deficit by more than $100 billion in five years. This is a crude but, I believe, useful measure of the net transfer from private to public uses resulting from the effects of inflation on tax payments.

The calculations leave out many adjustments. Interest on the public debt would be changed by the larger deficits and by the lower interest rates resulting from an end to inflation. My calculations have used average effects instead of the more accurate calculations that recognize the different effects on social security taxes, excises, and personal and corporate taxes. Lower inflation would also change the real returns to capital by reducing the tax on existing capital, thereby changing the composition of output, the size of capital gains and capital gains taxes, and the like. Adjustments to steady inflation by investors and consumers would undo many of the adjustments that have been made, for example reducing investment in land or gold stocks relative to investment in depreciable capital. All of these, and many other, effects on taxes, spending and output are ignored.

We cannot hope to end inflation by 1978 and remain on a path toward full employment. The first effects of the sharp reduction in the rate of monetary expansion will cause revision of plans. Those who accumulated inventories or planned production or spending on the assumption of sustained inflation must adjust planning to the new environment. Unemployment will increase and the growth of output and perhaps output will at first fall. Gradually, it will return to its growth path at a lower average rate of inflation, but government payments for welfare and unemployment compensation will be larger and tax collections smaller. The actual deficit would be much larger than the $162 billion if there is an attempt to end inflation suddenly. The $162 billion is an estimate of the effect of inflation on government revenues and outlays, not a projection of the effect on the deficit of an end to inflation.

In the past several years, we have seen that the economy can recover while inflation is ended gradually. A policy of reducing the growth rate of money by stages has brought a recovery from recession, expansion, reduction in unemployment and in inflation. Continuation of gradualism, I believe, can bring inflation to an end by the early 1980's. Despite growing evidence that the policy of reducing inflation has ended, I assume the policy continues, specifically that rates of inflation fall by approximately 1% per year to reach zero in 1982. Real growth is kept at the CBO's less vigorous expansion path. The gradual reduction of inflation may change the yearly numbers, but any early reductions would be offset by later increases.

The projected budget deficit falls for $46 billion in 1978 to $5 billion in 1982. Tax collections in 1982 are $518 billion, about $100 billion lower than under CBO projections, and outlays are lower by $65 billion. The budget is near balance with full employment and no inflation. The table below compares the budget position and GNP resulting from my assumptions to the CBO estimates.

Inflation, Taxes and the Deficit

Year	Growth of GNP (in percent)	My Assumptions GNP	Taxes	Deficit	CBO Assumptions GNP	Taxes	Deficit
		(in current dollars)			(in current dollars)		
1977	10.4	1884	362	-50.6	1884	362	-50.6
1978	8.8	2050	400	-46	2075	405	-46
1979	6.6	2186	436	-34	2259	454	-29
1980	5.6	2308	466	-26	2457	505	-14
1981	4.6	2414	494	-14	2673	562	+10
1982	4.0	2511	518	- 5	2909	621	+34

My proposed budget has very different consequences from the CBO budget. The share of GNP taken in taxes by the Federal government is reduced from 21.4% to 20.6%. Much of the reduction is the result of a small deficit instead of a budget surplus, but this is misleading. I have made no provision for the reduction in interest payments on the Federal debt that would result from the removal of inflation premiums in interest rates. Average interest rates on the outstanding debt in 1982 would fall from the 7% projected by the CBO to 3 or 3-1/2%, so after allowing for the larger deficits, there is a reduction of $15 billion or more in outlays.

It would be a mistake to attach too much reliance to any of the estimates or projections five or six years ahead. The estimates show that a balanced budget, a smaller share of GNP absorbed by government and an end to inflation are feasible and compatible goals. By 1978, the projected budget deficits can be financed with a rate of increase in the monetary base that is consistent with slower inflation and no further increase in the ratio of government debt to base money. No later than 1980, the financing of the deficit permits the Federal Reserve to slow money growth and reduce outstanding public debt to make room for additional financing of housing and private capital formation.

An Alternative Program

The difficulties I find in the administration's program do not lie as much with the inaccuracies of the projections as in the requirements on government. All of the projections assume that Congress holds spending to levels no higher than the projections. These allow for expansion of existing programs, but permit no additions. Every new program must be matched by a reduction in an existing program.

Does anyone believe that Congress or the administration will behave in this way? The $50 billion deficit for fiscal 1977 had been increased to $70 billion by January and will be increased further. A deficit of more than $75 billion for fiscal 1977 seems likely, and the new administration and the new Congress have only begun to search out new ways of spending. The increase in fuel costs is seen as an opportunity to grant additional relief to families that pay more for heating. At the same time, there are proposals for additional stimulus for the economy on the grounds that higher spending on utulities must be offset to cushion the shock to employment. Apparently, those who receive the additional payment for food or fuel are expected to withhold their receipts from the spending stream, so government must correct their behavior.

I will not dwell on the obvious reasons why this argument is wrong. Even if it were correct, it is fine tuning with a vengeance. Every shift in spending brings a new program or an addition to an old program. The government takes responsibility for smoothing out the ripples in economic life disregarding that their forecasts of the ripples are subject to large errors and that their actions create uncertainties about the future that are at times as disturbing and unsettling to the economy as the ripples they attempt to smooth.

We need not continue to restrict freedom and reduce efficiency in the interests of full employment. There is an alternative path to full employment that uses our resources, increases freedom and encourages efficiency.

Inflation, restrictions, prohibitions and regulations not only reduce the return to capital and labor and discourage investment, but they transfer resources to less productive uses. If we reduce the army of regulators to a brigade or platoon, we raise productivity by transferring resources from less efficient to more efficient activities. Those engaged in negotiation over the rules and their application are directed to more productive tasks. Productivity increases and saving is attracted from the many other places in the world where restrictions, disencentives, and regulations lower the rate of investment in new and more productive facilities.

Many countries have followed the path we have followed. They, too, restrict freedom and efficiency in the use of resources, limit returns to investment, and create uncertainty about the future. By increasing freedom and encouraging efficiency, we can raise our standard of living and develop opportunities for employment at higher real earnings and with more freedom to decide how we spend our incomes.

This is a long-term program, for improving the efficiency with which we use resources and improving the performance of the economy. Unemployment is generally regarded as a current problem that we must solve sooner than my proposals permit. If this is correct, we must recognize that much of our long-term unemployment is the result of past policies particularly the minimum wage law and restrictions on entry into professions and occupations written into local and national laws. Few actions would have more effect on long-term unemployment of teenagers than the removal of minimum wage laws and other barriers to entering the labor market.

Ending inflation, increasing employment, reducing the burden of a large government, increasing efficiency and encouraging freedom are compatible goals that can be achieved by this administration, if they avoid three temptations: to fine tune the economy, to preserve and nurture the growth of bureaucracy, and to believe that they can choose to increase employment now and reduce inflation later.