A Tax Increase Is Essential

Statement of ALFRED HAYES, *President, Federal Reserve Bank of New York, before the House Ways and Means Committee, Washington, D. C., September 14, 1967*

Mr. Chairman and members of the Committee: I am pleased to be here at your invitation to discuss the President's tax recommendations. I propose to address myself to the major component of this program—the 10 per cent surcharge on personal and corporate income taxes. I strongly support this proposal. I believe it is in the national interest. A tax increase is essential if we are to avoid an undue risk of severe price inflation and the evils of recession and unemployment that would follow. It is essential if we are to avoid an undue risk of finding ourselves facing the same financial pressures, and the associated slump in mortgage lending and home construction, that characterized much of 1966. It is essential if we are to maintain the strength of the dollar in international markets.

I strongly believe that unless a tax increase is promptly enacted the country may well face one of the worst outbreaks of inflation in many years. The private sectors of the economy give every indication of resuming a high rate of growth at a time when the Federal and state and local governments are preempting an abnormally large share of potential increases in the national output of goods and services. The war in Vietnam is placing especially heavy demands on the economy, and defense spending is expected to climb still higher over the coming year. In this context, the threat of renewed overheating in the economy is very real. At the same time, wage settlements far in excess of past and potential productivity gains have added a new dimension to the problem. There is, I believe, a clear and present danger that a return to excess demand pressures, piled on top of wage pressures, will result in an inflationary spiral, with both demand-pull and cost-push playing a role.

Such an inflationary development would have severe consequences for the longer run growth and vitality of the economy. It would discourage thrift and would distort business incentives to invest. It would lead to speculative excesses, sowing the seeds of an eventual economic downturn. Rapid price inflation would also aggravate some of our more pressing social problems, especially those of our cities. Increases in prices work to the greatest disadvantage of those in the lowest income brackets who have least ability to adjust their incomes upward as the cost of living rises. Inflation would thus tend to undercut the effectiveness of the many existing and proposed programs to improve the economic situation of the poor and aged. Because of this, inflation is correctly called the cruelest tax of all. Inflation also has other socially undesirable effects on resource allocation. Home building could be expected to suffer once again, and at a time when there is a growing need to improve national housing conditions, especially for low income families. The flow of savings would be distorted, raising new difficulties for those borrowers—especially lower income families and small businesses—who have least ability to compete in the markets for loanable funds, and for those thrift institutions which specialize in home mortgage lending.

Speculation, instability, and high interest rates are characteristics of financial markets during inflationary periods. No doubt, the current financial situation, characterized by speculation in common stocks, record or near-record interest rates in the bond markets, and a general tone of uneasiness, reflects a growing and increasingly widespread belief that the outlook is inflationary. Worries about exceptionally large Federal deficits and Treasury borrowing needs, and their implications for price inflation and upward interest rate pressures, dominate the atmosphere in the financial markets. There is no doubt in my mind that a tax increase, which would substantially cut both the Federal deficit and the Treasury's borrowing requirements, would help to steady our sensitive financial markets.

A tax increase would also do much to protect the international economic position of the United States. By restraining inflation, it would help our trade balance, a vital

element in any solution to our overall balance-of-payments problem. The competitiveness of our exports in international markets would be better preserved, and the threat of an upsurge of imports would be lessened. At the same time, a tax increase would help demonstrate that the nation is prepared to make the domestic sacrifices that are essential for successful handling of its international commitments and obligations.

DOMESTIC ECONOMIC TRENDS

After a short period of economic hesitation early this year, the evidence now points convincingly to a resurgence of overall economic expansion that would outrun the nation's productive capacity. Although there is now some unutilized labor and plant capacity, this margin is probably adequate to accommodate for only a short period the fast pace of economic expansion that now seems probable. Once these idle resources are absorbed, the inflationary pressures are likely to be much more severe than those encountered last year.

The weakness in the private economy over the past half year or so, while traceable in part to less vigor in consumer spending and in plant and equipment outlays, was centered primarily in a sharply reduced rate of spending on inventories. Indeed, final demand—total purchases of all goods and services other than inventory spending—remained very strong and continued to grow, stimulated of course by heavy outlays by the Federal and state and local governments. The fact that the inventory correction failed to produce greater weakness in other areas of private demand is itself evidence of the basic strength of the economy.

Within the first six months of the year, moreover, the trend of the economy was definitely upward: the second quarter of the year was both stronger and better balanced than the first quarter. The retarding effect of the inventory correction on overall economic activity was much reduced as midyear approached. At the same time, the spring and early summer months saw a distinct revival of consumer spending and an impressive further recovery of construction starts on new homes and apartments. Evidence of the sustained strength of business confidence was visible in the results of several surveys pointing to continued very high —and probably rising—spending for new plant and equipment.

Turning to the outlook, I believe the economy will be very strong—indeed, without a tax rise, excessively so. In the area of final demand we can expect continued strong gains in consumer spending, as spendable incomes increase and as the recent high rates of personal savings fall back to more normal levels. We can look for further substantial recovery of the housing industry if mortgage conditions do not tighten greatly. And we can expect a return to growth in plant and equipment spending as investment incentives and business profits benefit from higher plant utilization rates. In the very important area of inventory spending, the substantial amount of adjustment already accomplished, plus the prospects of rising business sales, suggests a return shortly to more normal levels of inventory accumulation. But even a stabilization of inventories around present levels would have a profound effect on the economy by eliminating the most important force restraining business activity earlier this year. The current automobile strike will have some depressing effect on the economy while it continues, but subsequently economic growth will be all the stronger as lost production and lost sales are made up. It does not, therefore, change my general assessment of the outlook.

In the absence of a tax increase, the large Federal deficit would be an excessive stimulant for the economy. When the Federal Government pays out far more to the private sector than it withdraws in the form of taxes, it adds greatly to the spendable incomes of businesses and consumers, thereby tending to produce greater private demand for goods and services than would otherwise be the case. These greater demands would add to the expansionary forces already present in the private sectors of the economy.

I fear that in this context, and without a tax increase, price inflation may well develop on a scale unparalleled in many years. Excessively strong advances in overall demand would reinforce the pressures on prices that already exist because of wage increases that are now generally well in excess of productivity gains. We have already had a disturbing rash of price increase announcements. Higher prices in turn are likely to generate still greater wage demands, and may lead to a situation in which wage and price increases interact with one another to produce an inflationary spiral. I am also afraid that inflationary expectations are already beginning to take hold, and that delay in enacting a tax increase might weaken the contribution to price stability that such a tax increase could make.

THE BALANCE OF PAYMENTS

The outlook for our increasingly critical balance of payments would also be improved very importantly by a tax increase. The avoidance of excesses in the domestic economy is vital for the protection of our trade position. I am particularly concerned with this since I believe an expanded trade surplus to be the principal hope for a reduction of our balance-of-payments deficit. First, in

helping to curb inflation, a tax increase would aid in preserving the competitiveness of domestic producers in world markets. Second, and especially important for the short run, fiscal restraint would help prevent the surge of imports that typically occurs when domestic demands for goods and services exceed the supplies available from domestic producers. Finally, I might also note that passage of a tax increase, underscoring the resolve of the Congress and the President to foster domestic economic stability, would do much to protect our gold reserves by providing needed reassurance to foreign holders of dollars that the value of those dollars will be maintained. I do not wish to imply that enactment of a tax increase will provide a ready-made solution to our balance-of-payments problem. But without a tax increase the situation may easily become worse rather than better, with adverse effects on our overall international position, both economically and financially —and politically.

THE FINANCIAL SITUATION

So far I have stressed the need, domestically and internationally, for a tax increase to assure reasonably noninflationary economic growth. The uneasy financial atmosphere also calls for a tax increase. I believe that the present record or near-record high interest rates in the credit markets primarily reflect the collective judgment of borrowers and lenders that inflation and huge Treasury borrowing demands are likely over the next year or so. The importance of market forces in the rise of interest rates this year is all the more striking in view of the ready availability of bank credit.

The rise in long-term rates, which has brought the general structure of capital market yields back to the 1966 record peak, has had many causes. The widespread desire of business to rebuild liquidity, following the drains that occurred in 1966, has certainly been an important factor in the market. The liquidity positions of business still remain comparatively low, and there are as yet no convincing signs of a significant cutting back of the demand for long-term funds by private borrowers. At the same time, the recovery of residential construction and home purchases portends a very rapid expansion of mortgage loan demand in coming months. Moreover, borrowing by state and local governments continues at record levels; the wide variety and high social priority of purposes for which this borrowing is being undertaken suggest that the demands of these borrowers are unlikely to moderate in the foreseeable future.

Another basic factor in heavy borrowing demands has been the fear of still higher interest rates later on—partly based on doubts as to whether necessary measures of fiscal restraint would be applied. Basically, borrowers and lenders are reacting in a predictable manner to fears of a return to inflation which diminishes the value of fixed-income securities. Striking further evidence of such inflationary hedging in the financial markets is to be found in the recent burst of speculative activity in the stock market—activity characterized by excessively wide price movements in lower quality issues and record high levels of trading volume.

The present uneasy financial climate stems in good part from the Federal deficit and the prospects for record peacetime borrowing by the Treasury. Recently, as the current period of heavy financing approached, Treasury bill rates increased at a very sharp pace, providing clear evidence of the market's great concern over the complex financing problems that will confront the Treasury in coming months, especially if no tax increase is forthcoming.

ALTERNATIVES TO A TAX INCREASE

The question may be raised whether there are any practical and acceptable alternatives to a tax increase. It seems to me that there are only two other means of effectively cutting down excessive overall demand: (1) prompt and very substantial reduction in total Government spending, (2) a severely restrictive monetary policy.

The Federal budget deficit and overall demand can, of course, be reduced by cutting expenditures, by increasing taxes, or by some combination of both. In his message to the Congress on August 3, the President emphasized the importance of restraint on Federal expenditures. They should be carefully controlled and reduced as much as possible. But it is not realistic to expect that sufficiently large cutbacks in spending can be accomplished with sufficient promptness to make a tax increase unnecessary. Indeed, even if large cutbacks were feasible, the time required to explore possibilities for cuts and to make them effective would unduly postpone the fiscal restraint that is so badly needed immediately.

As for monetary policy, it seems to me that principal reliance on this alternative would fail to attack the problem at its basic source. Since so much of the fiscal stimulus and financial pressure is caused by a large Federal deficit, fiscal measures would go to the heart of the problem. With interest rates already at record or near-record levels, a drastic cutting back on the supply of credit might bring on distortions in financial flows much along the lines of 1966. The burden of economic restraint would again fall hardest on the housing industry, on the thrift institutions that specialize in the mortgage market, and more

generally upon those borrowers who have the least ability to compete for the available supply of credit. Believing as I do that this would be the outcome of almost exclusive reliance upon monetary restraint, I am led inevitably to the conclusion that a highly expansionary fiscal policy is clearly inappropriate under present economic circumstances.

THE RISKS IN A TAX INCREASE

I think it is clear from what I have already said that I do not share the fear, frequently expressed in these hearings, that a 10 per cent tax increase would run a high risk of tipping the country into recession. It is true that an excessively strong economic expansion is still more a forecast than a reality, but policy decisions aimed at economic stabilization—fiscal as well as monetary—must always rest in large part on forecasts of future developments made on the basis of the best information and judgments currently available. The forecasts and judgments may, of course, prove to be wrong, but this possibility does not excuse a failure to act on the basis of clear probabilities.

It is important to remember that any policy action is reversible or capable of offset, should that prove necessary. Fiscal restraint applied through a tax surcharge could be quickly reversed by simply removing that surcharge sooner than otherwise contemplated. And monetary policy remains available as a flexible tool.

However, in my assessment, the President's 10 per cent surcharge proposal runs a greater risk of being less than what is needed to achieve economic stability rather than more. If some of the contingencies mentioned in the new fiscal 1968 budget estimates—notably an extra $4 billion rise of defense spending—occur and result in an even larger rise in total spending, I am afraid that a 10 per cent surcharge might prove too little. But that situation is not with us today. I trust that the 10 per cent tax surcharge will be adequate on the assumption that Federal spending overall can be held to the total now estimated. I support the tax surcharge at the 10 per cent level and urge its enactment at the earliest possible date.