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Statement by

Henry C. Wallich

Member, Board of Governors of the Federal Reserve System

before the

Temporary Subcommittee on Industrial Growth and Productivity

of the

Committee on the Budget

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I appreciate this opportunity to discuss with you my personal views on the prospects for increased productivity growth in the United States and particularly on the role that the federal government should take in such an effort. Your outline lists an impressive range of issues in this area. I hope it is agreeable to the committee if I address myself principally to the interaction between productivity and inflation and to implications of financial and regulatory actions by the government.

The decline in productivity is a familiar fact. Though all its roots are not fully understood, I believe that in good part they are related to inflation. Inflation hampers business investment, an important source of productivity, by distorting reported profits, which results in excessive taxes, thereby reducing the return on investment. The uncertainty created by inflation raises costs by requiring higher risk premia and generally interferes with business planning. To raise productivity, one major contribution would be to lower the rate of inflation.

But there is also an important reverse relation, running from productivity to inflation. This causal nexus involves a consideration of trends in unit labor costs -- defined as the total compensation paid to workers divided by the output they produce -- which most economists believe are the most important determinants of underlying price trends. This belief arises from the fact that labor inputs account directly for about two-thirds of the costs of producing the GNP. Any tendency for price increases to fall short of the trend in these costs means that other unit costs of production, or more likely profit margins, must be reduced. Since some minimum level of profit must be maintained for firms to remain in business, the inflation rate

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cannot remain below the rate of increase in unit labor costs for any extended period. In the short run, of course, other factors, including shifts in demand, resulting perhaps from business fluctuations caused by changes in government deficits or the growth of money supply, or disruption in supplies in industries such as energy and food, can pull prices away from unit labor costs. But in the long run, prices will follow unit labor costs. Changes in unit labor costs in turn are determined by the difference between wage increases and the rate of improvement in worker productivity.

In this framework, we can see the serious implications of the deteriorating trend in productivity. In the earlier postwar period, labor became accustomed to increases in real wages in the order of 2-1/2 percent or so that accompanied the productivity gains of that era. These expectations have adjusted sluggishly to the slower growth of productivity. Thus, efforts are made today by workers to increase real wages at a rate faster than the advance in output per hour. Such efforts, however, only tend to squeeze businesses. Firms then find that they must increase prices at ever increasing rates to maintain profitability. The resulting acceleration in prices frustrates labor's original efforts to increase its standards of living. These efforts run into the hard fact that there is not enough additional output to meet these demands. Inflation rates consequently trend up.

This analysis underscores the importance of improving our productivity performance. But to compare productivity with the rate of inflation or nominal wage demands is not a plausible way of looking at

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the problem. Wage demands, even though stated in current dollars, take into account the rate of inflation. In other words, they are really demands for real wage increases. The real increases demanded may be relatively moderate, and not much above productivity gains. But it is the difference that is decisive, because it can give rise to an upward wage-price spiral. An increase in rate of growth in productivity above the level of real wage demands could be converted into a winding down of the inflation rate. The increase would not have to be large, relative to the rate of inflation, since real wage demands also tend to be low relative to our present very high rate of inflation.

Those who argue that a one or two percent gain in productivity would not make much of a dent in our high rate of inflation, ignore the dynamic aspect of the relationship between efforts of labor to increase real wages and the productivity gains that make these increases possible. If the trend rate of increase in productivity is larger than the real wage gains sought by employees, and if the degree of competition does not diminish, firms will be able to increase prices by less and less while still maintaining profits. If this deceleration continues to work over time, the gains in terms of reducing the inflation rate could be substantial. At the same time, the reduced rate of price increase will enable labor to realize the fruits of productivity gains in rising standards of living.

A wide range of federal programs has been offered as a means of bolstering productivity. Many of these would require more government intervention and regulation in private markets. In my view, most of the regulatory

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and interventive proposals may do more harm than good with respect to productivity. The costs of some of them are indirect and not readily apparent. Many government regulations indeed are plainly adverse to productivity. This is not likely to be remedied by piling regulation upon regulation.

Some forms of market intervention, including price supports, wage and income supports, import restrictions, and a variety of regulations, seek to insulate certain individuals or business firms from market pressures. While the purposes of such protection may be worthy, one inevitable byproduct of these policies is to reduce efficiency. Governmental actions may lead to a suboptimal allocation of resources, thereby limiting the growth potential of the economy, or they may simply add to costs, thus contributing to the inflationary bias of the system. These risks are present whether the market pressures originate at home or abroad.

One of the most common types of suggestions for government actions to encourage productivity growth has been a call for intervention in the credit markets to stimulate increased capital investment by business. Programs of this sort include interest-rate subsidies, direct government loans, or loan guarantees designed to affect credit allocation to competing groups of borrowers. Such programs seem to imply that funds are not available from private lenders for creditworthy borrowers. That, however, is likely to be the case only in small part, given the efficient nature of our capital markets. Thus, pushing money into some particular sector by means of subsidies to lenders may result to some extent in pushing other money out of that sector. Also, to the extent that borrowers who previously

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did not receive credit now can draw on the limited pool of available savings, other borrowers may be crowded out. That is the ultimate result of the already enormously expanded demands of the federal government upon capital markets, represented by its direct deficit and the borrowing of off-budget and sponsored agencies, which in fiscal year 1981 are estimated to total up to $110 billion. That amount is of roughly the same order of magnitude as total personal saving.

The rationing of credit through mechanisms other than the normal adjustment of interest rates to balance supplies and demands for funds would also carry a very expensive price tag in terms of market distortions. For example, managers of firms might be less inclined to produce their products efficiently if government programs ensured credit supplies at below market interest rates. Supplies of subsidized credit might exceed what would strictly be needed to achieve specific purposes, and so might be partly wasted. Given the advantages of doing so, unworthy or nonessential purposes would be dressed up as deserving, creating excessive demands on the program or depriving some of the more deserving. Finally, government measures to finance or otherwise subsidize, in the nature of our democratic process, are likely to focus upon trouble spots, such as old and perhaps inefficient firms and industries. In that way, activities that the market would eliminate would tend to be preserved, and the progress of productivity would be impaired. In general, government intervention in credit allocation tends to politicize financial markets as decisions would have to be made as to what types of loans are to be favored over other uses of funds. Because of these distortions, an expansion of our governmental presence in credit markets is more likely to depress the productivity performance of the U.S. economy than to improve it.

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If Congress were to decide that actions to stimulate investment are necessary in order to boost productivity, I would suggest that changes in the federal tax structure would be potentially the most fruitful approach. The logic of this approach rests in part on the role federal taxation has played in discouraging investment by reducing its profitability. This is an especially important problem during inflationary times if, as is the case today, tax deductions for depreciation are allowed only on a historical cost basis, rather than at a rate that enables the plant and equipment to be replaced at current prices.

On several previous occasions during the postwar period, incentives to, and financing of, business capital formation have been increased through a variety of mechanisms. These include accelerated depreciation, an investment tax credit, and a reduction in corporate profit tax rates. Not surprisingly, a similar set of proposals has been advanced in recent years to help improve capital formation and, hopefully, the productivity problem. Judging from studies of the effects of tax incentives to stimulate investment introduced in the past, these types of incentives would probably have their desired effects.

Proposals also have often been made to increase investment by stimulating personal saving, and have indeed been used in various countries. Given the very adverse treatment that American savers have received through the interaction of inflation, regulation, and the tax system, I have considerable sympathy for such proposals on equity grounds.

For example, we must seriously ask ourselves whether it makes sense to tax as savers' income the inflation premium inherent in present day

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high interest rates, thereby driving interest rates still higher. By the same token, I would question the wisdom of continuing to allow a tax deduction to borrowers for the same premium, with the same upward effect on interest rates. In this regard, we must also ask ourselves whether it makes sense to subsidize homeowners through tax deductibility of the inflation premium at a time when the resulting high mortgage rates cause a depreciation of old mortgages that creates serious pressures for financial institutions serving housing.

On efficiency grounds, however, I must question the merit of subsidies to particular forms of saving. Their main effect is likely to be to reshuffle the allocation of savings among savings instruments, rather than to raise total saving. I feel less certain about this judgment in relation to a device such as employed in France and known as the Monory Law (Law for the Channeling of Savings to the Financing of Enterprises), which allows a tax deduction, within limits, for investment in equities. Even though this measure may have no great effect in promoting saving, it seems to raise share prices and thus reduce the cost of equity capital as well as improve the structure of financing.

Another way to increase available savings is to reduce the demands made by the public sector upon financial markets. Moving toward budget balance would free for private sector use funds far greater than are likely to result from most schemes designed specifically to increase savings. Thus, while a tax cut has much to recommend it in terms of changing incentives, it should be approached circumspectly from the point of view of its budgetary

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impact. Right now taxes are far too high to permit adequate incentives and savings. But to increase the deficit would be inflationary, and tax reduction must, therefore, be conditional on progress in reducing government spending. Any tax cut matched by expenditure restraint would be helpful, but in the light of our need to stimulate productivity, a cut directed toward raising investment, in tangible and also human capital, would be particularly appealing.

For its part, the Federal Reserve is attempting to foster an environment that should facilitate a reduction in overall inflation pressures and thus promote more vigorous growth and prosperity. A reduction of inflation, as I noted earlier, should make an important contribution to productivity. Also, a lower inflation rate is the only feasible way of reducing interest rates. An "easier" monetary policy might reduce interest rates for a short period, perhaps on the order of a few weeks or months. But, as soon as its inflationary implications became obvious to the market -- and this would not take long -- interest rates would move up with expected inflation, as they have done before. Thus, the Federal Reserve really has no option other than to exert restraint in order to set the stage for the long-run gains in employment and productivity that we have every right to expect from the American economy.

Since your committee's outline refers to social compacts and other organizational arrangements, I would like to close by mentioning an item of personal interest that may not be unfamiliar to you -- the tax-oriented incomes policy usually referred to as TIP. There are many forms of TIP that can be broadly classified into proposals that depend on

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the "carrot" and on the "stick" approach, respectively. My preference is for an approach that levies a tax on firms granting excessive wage increases. This approach would be simpler administratively, and probably more effective than the alternative. In my judgment, such a device could be enacted once public concern about the persistence of inflation began to exceed the natural reluctance of business and labor to accept such a proposal.

On the other hand, I am aware that the carrot approach might be more appealing and easier to enact than my stick approach. In view of the current budgetary problems, however, such a TIP, would only be appropriate if and when general economic conditions or spending restrictions justified a reduction in federal taxes, the benefits of which could then be withheld from noncompliers. The Economic Report of the former Council of Economic Advisers explores various kinds of TIP in detail and concludes that it would be too late to tie a TIP to a 1981 tax cut, though it might be considered on a subsequent occasion. I would just say that any tax cut proposal should be examined with a view to whether a TIP could be associated with it.

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