

Fiscal Policy, the Fed, and the Prospects for Prosperity

keynote address by
Jerry L. Jordan
President and Chief Executive Officer
Federal Reserve Bank of Cleveland

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I. Introduction

- A. Acknowledge introduction and audience.
- B. Compliment CATO for promoting sensible ideas and philosophy.
- C. My comments this morning are titled "Fiscal Policy, the Fed, and the Prospects for Prosperity."
 - 1. I want to discuss how political organizations and rules affect prosperity.
 - 2. I'll suggest some specific rules for fiscal policy and monetary policy.

II. Organizations, Rules, and Markets

- A. Political institutions affect prosperity:
 - 1. If they improve markets---they enhance prosperity.
 - 2. If they interfere with markets---they retard prosperity.
- B. Political institutions include organizations and rules.
 - 1. Governmental organizations include...
 - 2. International organizations include...
 - 3. In general, organizations affect prosperity by the rules they impose.
- C. Examples of prosperity-enhancing rules are:
 - 1. Property rights.
 - 2. Contract enforcement.
 - 3. Freedom of speech and press.
 - 4. Standards for weights and measures.

D. Examples of prosperity-retarding rules are:

1. Wage and price controls.
2. Interest rate controls.
3. Credit allocation and industrial policy.
4. Controls on foreign exchange transactions and capital flows.
5. Trade restrictions.

E. Unfortunately, policymakers often try to:

1. Help the already-prosperous by restricting competition.
2. Help the less-prosperous through wealth redistribution rather than wealth creation.
3. Gain political support through policies that help in the short run but hurt in the long run.
4. Solve problems by imposing more rules.

F. Experience of the 20th century shows that successful policies are those that enhance the effectiveness of markets.

1. Central planning has failed:
 - a. Collapse of Soviet Union and Comecon.
 - b. Former West Germany is more prosperous than former East Germany.
 - c. South Korea is more prosperous than North Korea.
 - d. Taiwan is more prosperous than the mainland.
2. Good policies are more important than possession of natural resources:
 - a. Resource-poor Japan and Switzerland are rich.
 - b. Resource-rich Brazil, Russia, and Africa are poor.
 - c. Resource-poor Hong Kong and Singapore are prospering.
3. Good public policies attract productive resources; bad policies repel resources.
 - a. If resources are free to move, policymakers will have to compete for them through good policies.

III. Some Policy Rules

- A. Let me now suggest some specific monetary and fiscal policy rules that will improve the operation of markets and thereby enhance prosperity.
- B. Clear rules that limit the use of discretion by monetary and fiscal policymakers can promote prosperity.
 - 1. Households and businesses will face less uncertainty.
 - a. They can make better decisions about consumption, saving, investment, and production.
 - 2. Fewer short-sighted, politically-motivated policies will be imposed.
- C. **RULE:** Monetary policy should pursue sound money.
 - 1. Sound money enhances prosperity in three ways:
 - a. It avoids capricious redistributions of wealth.
 - (1) Resources won't be used to avoid redistribution.
 - (2) So, it is akin to a technological advance.
 - b. It encourages saving and investment.
 - (1) Inflation interacts with tax system to discourage saving and investment.
 - c. It facilitates planning of production, consumption, and saving.
 - 2. False dichotomy.

- D. **RULE:** Congress should mandate that the central bank achieve price level stability by a certain date and maintain it thereafter.
1. The mandate would increase the Fed's credibility.
 2. Credibility would facilitate achieving sound money.
- E. **RULE:** Congress should mandate that monetary authorities have no objectives regarding short-run growth of output, employment, or other real magnitudes.
1. Sound money helps with all of these in long run.
 2. Using monetary policy to pursue them directly in short run sometimes impedes their achievement in the long run.
- F. Turn now to fiscal policy.
- G. **RULE:** Don't manipulate budget deficit for countercyclical purposes.
1. Changes in the levels of government expenditures or tax revenues have little lasting effect on total spending in the economy.
 2. No balanced-budget multiplier.
 3. No deficit-spending multiplier.
 4. Any effect is transitory and quickly reversed.

- H. **RULE:** Tax proposals and spending proposals should be evaluated for their effects on incentives and resource allocation.
1. They can affect incentives to work, save, and invest.
 2. They can shift resources between consumption and investment.
 3. In these ways, government spending and taxing can change the long-run growth path of output.
- I. **RULE:** Governments should not impose taxes that discourage working, saving, investing, inventing, innovating, or owning and using productive resources.
1. To tax something is to discourage it.
 2. The primary incidence of taxation should fall on consumed income.
 3. A tax burden on individuals can't be avoided by levying taxes on businesses. Only individuals ultimately pay taxes.
 4. Tax policies should be evaluated by considering whether individuals bear the tax in their roles as workers, consumers, or investors.

- J. **RULE:** Policymakers and voters should not act on the myth that the burden of taxation is determined by the current level of tax revenues.
1. True tax burden is determined by the amount of government spending.
 2. Ultimately, all government expenditures must be financed by:
 - a. present or future explicit taxation,
 - b. government money creation,
 - c. or gifts from foreign sources.
 3. Actions that reduce current tax revenue without decreasing either present or future government expenditures do not constitute a reduction in actual tax burdens.
 4. Conversely, decisions that reduce either the current level or the growth of government expenditures from what they otherwise would have been are a genuine reduction in tax burdens, even if explicit tax revenue is not altered.
- K. **RULE:** Deficit spending should not be thought of as an alternative to taxation.
1. It is a method of deferring explicit taxation.
 2. It can encourage taxing through inflation.
 - a. Inflationary monetary policy can be viewed as an instrument of taxation.

- L. **RULE:** Deficit spending should be financed with inflation-indexed bonds.
1. Indexing reduces the temptation for government to finance its expenditures through inflation.
- M. **RULE:** Government should do only those few things that the market economy clearly cannot do well.
1. Because such a standard is difficult to apply, an alternative approach is to set a specific limit on government spending that can be altered only by constitutional amendment or super-majority of the legislature.
 2. The limit could be expressed as a share of national income or as a rate of growth.
 3. Part of the objective is to create an effective budget constraint on the government wherein opportunity cost cannot be ignored.
- N. **RULE:** Support programs should be means-tested so that income transfers to middle- and upper-income members of society are avoided.
- O. **TWO RULES** for retirement programs:
1. Government may choose to mandate, but should not administer them.
 2. They should be fully funded to avoid the negative effects on saving of redistributive pay-as-you-go schemes.

IV. Conclusion

- A. Rules that enhance the functioning of markets are much more essential to economic prosperity than are politically created and controlled organizations, no matter how well-intentioned their missions.
- B. If there is time, I'll be glad to answer some questions.