THE CASE FOR INCREASED TAXES

Remarks by

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Newspaper Day

November 4, 1967

South Dakota State University

Brookings, South Dakota

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In a previous incarnation, I was, as some of you may know, a tax lawyer. I made my living, such as it was, advising my clients how they might pay less in taxes and still stay out of jail. It may therefore seem a little strange that I come before you tonight to explain why you should all be paying more in taxes. And you are in a way all clients of mine. South Dakota is part of the Ninth Federal Reserve District; and in my present incarnation, as President of the Federal Reserve Bank of Minneapolis, I have a certain responsibility for the economic well-being of the district and its residents.

You will perhaps take what I have to say tonight as an elaborate plea on my own behalf. In part, it is. If Congress passes the President's tax proposal, I too shall have less money to spend; but for reasons I shall get into presently, my life will be a lot easier. There is, however, more at stake than a relatively easy life for me. In some measure, the economic future of the United States hangs in the balance.

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Originally, I had thought I would begin my remarks by summarizing the economic outlook, but I decided I should begin with a justification for beginning a talk on the need for increased taxes with a summary of the outlook. In Congress and elsewhere there has been a good deal of criticism of the administration for having based its call for higher taxes, not on present economic conditions, but on what it expected future economic conditions would be.

It is not clear what those who have criticized the administration for forecasting the economic future would have had it do. Possibly wait until a truly damaging inflation had emerged as a reality before calling for an increase in taxes. I would remind you, though, that a change in economic policy, whether monetary or fiscal, affects the shape of things, not immediately, but only after some considerable amount of time has passed. There is, as it were, a time lag in economic policy. When taxes are changed, months pass before the full effect is felt. But then to put off increasing taxes until inflation has become a reality is to be too late.

If the government is to do its job, which involves preventing inflation and keeping unemployment down to an acceptable level, it must forecast the future. Only by doing so can it act in time. This may be a sad truth. It is still, though, a truth.

It makes no sense to argue, as some have, that because the administration urged a tax increase to curb future inflationary pressures, its call for higher taxes should not be heeded. To argue this way is to get caught up in a logical snare. By opposing the tax increase, one makes a forecast of one's own--that there is no more inflation looming down the road. Let us be quite clear; those who have opposed the administration's call for higher taxes have made a forecast, even if only implicitly.

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What is truly at issue then is the accuracy of the forecast which government economists, including those in the Federal Reserve System, made late last spring, or just before the request for the imposition of an income surtax was sent to Congress. It is obviously too early to be sure, but the indications are, I believe, that the government's economists correctly guaged the course of the economy.

Last spring, you will recall, the economy was languishing. The recession expected by some observers had not come, but the economy was hardly buoyant. Even so, the prediction was made that it would soon pick up steam, and that upward price pressures would reappear. And consider what has happened. Over the first half of 1967 Gross National Product, measured in current dollars, increased on average $7 billion per quarter at an annual rate. But we are expecting the third quarter increase in GNP to be $15 billion, at an annual rate, that is, and unless the auto strike goes on and on, an even larger increase in the fourth quarter. Moreover, in the second quarter of 1967 our most broadly based price index, the so-called GNP deflator, increased about 2 per cent at an annual rate. But the deflator will likely increase nearly 4 per cent at an annual rate in the third quarter, and again in the fourth.

Developments since late spring suggest then that the forecast made by government economists is being borne out. And this forecast is for more, not less, inflation if there is no tax increase. I shall not bore you by reciting a long string of statistics, but let me sketch out in broad strokes what is likely to happen if the administration's call for higher taxes goes unheeded.

It seems reasonably clear that even without a tax increase there are going to be machines idle during 1968. Over recent years we have added enormously to our capital stock, so much that not all of it will be employed even if demand for final output increases beyond what we believe it will. It may puzzle you that I say this; a forecast of manufacturers having idle productive capital on hand is hardly one which argues for a tax increase. And, indeed, that there will be idle productive capital in 1968 should moderate such upward pressures on prices as develop. There is, however, another productive resource, labor; it is in short supply presently, and if taxes are not increased it will be in much shorter supply during 1968. But as the unemployment rate decreases, wage settlements get bigger and prices tend to increase. This is what our postwar history suggests.

The trend of recent months has been to larger and larger wage settlements. Unit labor costs have increased considerably, although in part because, with the slow-down in the economy, productivity has been increasing only slowly. Fortunately, we can look forward to productivity increasing much more rapidly than it has been. But even so, it is not going to increase anything like enough to offset the increase in money wages which is going to come if taxes are not increased. What we are expecting, then, should the administration's call for a tax increase go unheeded, are very strong cost pressures, or in other words a good deal of cost-push inflation.

Before going further, let me sound a cautionary note. Even if the administration's call is heeded, we likely will have some inflation in 1968. Having failed to increase taxes in 1966, we are bound to see prices increase some more yet. It would take an unthinkably disruptive dose of deflation to prevent the large money wage settlements of the past twelve months from being passed on in the form of higher prices. But if there is a tax increase, there will be less inflation than there otherwise would have been. It is important to recognize that an increase in taxes will not prevent further price increases. This is hardly an argument, though, for not increasing taxes.

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Nor can we afford to be casual about the prospect of more inflation. In a sense, the choice before us is not whether to increase taxes, but what kind of tax increase to impose. Inflation is after all a form of taxation. But it is a poor form, mostly because it is capricious and cruel in its incidence.

I would also stress, however, that we take grave risks if we allow further increases in prices. Despite all we have done, our international balance of payments still is in deficit. We have gotten by, although largely because we have been able to maintain a margin of exports over imports. Indeed, this margin was larger in 1966 than in 1959. But it was smaller in 1966 than in, say, 1964. And it will get smaller if we do not keep our prices down. Since Germany and the United Kingdom are just emerging from recessions, it is unlikely that European prices are going to increase much over the coming year. Thus, if ours do, we are going to lose part of the competitive advantage we sacrificed so to achieve.

But there is more at stake than whether we lose some export customers. There is the risk that if we do not soon improve our balance of payments position, foreigners are going to lose confidence in the dollar and we are going to lose more gold. If we do, the whole international payments mechanism could break down, and we would end up back in the 1930s, with every country imposing trade restrictions or shortsightedly interrupting the free flow of international trade.

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Strictly speaking, the prospect of inflation suggests, not necessarily that taxes be increased, but only that total demand for the nation's output be reduced. And there are various ways of doing this. Thus, the Federal Reserve might increase monetary restraint, which as we all know substitutes for fiscal restraint.

Think back, though, to 1966--the year of the great credit crunch. Perhaps you will recall what the summer of 1966 was like. Interest rates rose to levels not reached since 1921. The talk was of an impending financial crisis. Still, this was the fear of those who operate in the nation's financial markets.

There can be no doubt that 1966 was, over its first nine months, a year of increasing monetary restraint. And what effects did this increasing monetary restraint produce? Inflationary pressures were checked; let there be no mistake about this. But the monetary restraint which the Federal Reserve had to impose because there was no tax increase had a wrenching effect on the economy. It is only a slight exaggeration to say that the residential construction industry was wiped out. You are perhaps aware that housing starts, seasonally adjusted, declined from about 1,500,000 in March 1966 to a little more than 800,000 in November. Housing starts totaled over 1,500,000 in 1965, and in 1966 a little less than 1,200,000. A 20 per cent decline year over year is pretty impressive. Or as those in the residential construction industry might prefer to say, depressing.

Why this sharp decline in the output of housing is easily explained. With the increase in market interest rates, funds were directed from savings and loan associations and mutual savings banks. And those two groups of institutions bulk large as mortgage lenders.

For a variety of reasons, they could not raise their share and deposit rates sufficiently to prevent customers from turning to bonds and stocks. Or from turning to commercial banks, which through the first nine months of 1966 did all they could to get consumers' savings dollars.

I might add here that in increasing interest rates the Federal Reserve, although justified in doing so, nevertheless risked undermining confidence in the financial system. There were some savings and loan associations, for the most part among the less well managed, which almost went under during 1966. As a group, though, savings and loan associations are now in much better financial shape than they were at the beginning of 1966, and could withstand increased monetary restraint better than they did in 1966. It is not likely that the Federal Reserve would have to run the risk it did in 1966. Also, we have a law passed in September 1966 which in essence prevents financial institutions from competing much with each other, so if there were to be increased monetary restraint in 1968, savings and loan associations would not have to suffer the same intense competition from banks that they had to suffer in 1966. There is therefore reason to believe that even with increased monetary restraint, housing output would not decline as much in 1968 as it did in 1966.

It would, though, decline, and sharply. There is no getting around that housing output is affected most by monetary restraint. And next in line, one suspects, is output of investment goods, which the country needs if it is to increase its productive capacity. The point, then, is that monetary restraint alters adversely the composition of output. This is no argument for not using monetary restraint. It is an argument, however, for not using only monetary restraint. Which is what we have been doing.

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We would then be poorly advised to increase monetary restraint instead of increasing taxes. But what about cutting government expenditures? There is no denying that insofar as preventing inflation is the problem, cutting current expenditures--not appropriations, but current expenditures--is in theory as good a solution as increasing taxes. Whether expenditures are cut or taxes are increased, total demand for the nation's output decreases.

Cutting expenditures is not, however, an easy task. We are perhaps all agreed that, as a cab driver in Rome put it to me, "The government, she eats too much." But going beyond this to agreement on which government programs to cut back is very difficult. I am simply saying we are not all agreed on our social priorities.

I too am for cutting expenditures, but I see this nation as beset by terribly serious social problems. And although I would admit that these problems will not be solved simply by spending money, I would add that I find it hard to understand how we will solve them without doing so. To me, then, it would seem to make sense to cut government programs designed to solve problems which no longer exist, or are nowhere as acute as they once were. Doing this, we could expand programs designed to solve emerging problems, and still perhaps reduce total government expenditures.

And yet is it not in the nature of democratic government that when expenditures are cut, new programs, not old ones, suffer? This may not, though, be inevitable. If expenditures are cut in haste, it is.

But what about a detailed study of federal expenditures? It is surely worth a try.

Fearful as I am of what programs will suffer if government expenditures are cut substantially, I would prefer for now to increase taxes and over a longer period of time work hard--and I would stress this, "work hard"--to eliminate low-priority spending. But this is, as I would admit, a matter of preference, and I should not abuse the honor of being asked to speak to you by running on any longer with a description of mine.

I would, however, add this note of warning. Even if you would prefer to see expenditures cut, be realistic. In the end, there are not going to be sufficient cuts in current expenditures. Is there anyone here who believes that nondefense expenditures will be cut enough to make a tax increase unnecessary? As an abstract possibility, they perhaps could be, although even this is doubtful. But even if they could be, will they?

It is tempting to look at government expenditures of $135 billion and say "Surely this total could be cut by $8 to $10 billion!" (This $8 to $10 billion is about the increase on tax receipts that can be expected if Congress imposes an income surtax.) But remember that discretionary expenditures do not amount to anything like $135 billion. Taking out defense expenditures, interest payments, expenditures on veterans' programs, etc., one ends up with a discretionary spending total of $21-23 billion. And $8 or $9 or $10 billion seems an awfully big share of even $23 billion.

It would be foolish, I believe, to quarrel for long about which expenditures to cut, or about who should take responsibility for cutting expenditures, and thereby delay until too late the passage of a bill to increase taxes.

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Let me now before stopping recount my argument. The economic outlook is bullish. It suggests an intensification of inflationary pressures, and therefore that something be done to restrain total demand for the nation's output. The Federal Reserve could perhaps shoulder the entire burden, as it did in 1966. But this would be good neither for the Federal Reserve nor, more importantly, for the country. It would be better to increase taxes or cut government expenditures. Which would it be better to do? This depends on one's prejudices, or more kindly on one's judgment of how pressing our social problems are. Realism would suggest, though, that expenditures are not going to be cut sufficiently, and that therefore we would be well-advised to pass a bill temporarily increasing taxes.

In conclusion, I can only add that I would sleep a lot better if I were sure a tax bill is going to be passed soon. And I would emphasize that word "soon." A tax bill passed next April, say, will do precious little good.