

FACING UP TO OUR ECONOMIC PROBLEMS:  
A SUGGESTED PROGRAM

S t a t e m e n t

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Since the start of the year, the United States economy has been experiencing severe inflation coupled with negative real growth. This "stagflation" has been the combined result of: the sharp jump in the price of Mid-East oil; the run-up in farm commodity prices during 1973, their retreat and then further advance in 1974; the slowdown in productivity that usually accompanies a decline in production, compounded by the need to devote a portion of investment to cleaning up the environment; and the attempt by business and labor to recoup losses in real income and profits generated by previous cost increases and, to some extent, the distortions of mandatory controls. Consumers, troubled by severe inflation, the uncertainty and seeming inequity of government policies, and by the rise in interest rates and decline in stock prices, have cut spending in real terms, particularly for automobiles and new housing. Business spending for plant and equipment has risen in nominal terms but only managed to remain stable when adjusted for price increases.

If monetary and fiscal policy hold to their present course--a 5 1/2 percent growth rate for the money supply, no change in tax rates, and a \$305 billion total for federal expenditures in fiscal year 1975--then the most likely prospect for the economy till mid-1975, barring any further change in oil and farm commodity prices, is for continued negative real growth, a rise in the unemployment rate to above 6 1/2 percent, and a decline in the rate of inflation as measured by the GNP deflator to approximately 7 percent. Beyond mid-1975 the inflation rate will continue to come down, but progress can be expected to be slow.

The calling of economic summit meetings by the administration suggests a healthy openness to a wide reach of ideas designed to achieve reduced inflation without prolonged stagnation. The following criteria can be of assistance in separating useful from inappropriate suggestions:

First, policies specifically designed to reduce inflation by generating sizable amounts of unemployment are unworkable and unacceptable.

Second, a quick solution to inflation does not exist. This implies that halting inflation will take an extended period of time and inevitably involve higher rates of unemployment than we have been willing to accept in the past: it may not be possible to hold unemployment below 6 1/2 percent next year with any program that has a chance of restoring equilibrium by 1976.

Third, since the rate of inflation cannot be reduced in a painless manner, only a program that provides for a fair sharing of the burden of adjustment will be acceptable and workable.

Fourth, proposals for relaxing environmental standards as a means of holding down prices are largely illusory. There may well be valid reasons for changing such standards, but it must be recognized that apparent price reductions bought at the expense of the environment may mean a lower price on market traded goods and a higher "cost" on a nonmarket good, the environment.

Fifth, increased productivity is the only "painless" way of raising income and output while holding down costs and prices. This implies reducing barriers to competition in government, industry and labor. It also implies stimulating investment, and the savings to finance it.

Sixth, complex and intractable as the problems of stagflation may be, there must nevertheless be an early announcement of an understandable, implementable program designed to replace fear and divisiveness with joint sacrifice and hope. Proposals for longer-term structural changes should follow quickly.

The following policy suggestions are put forward in the light of the above criteria:

First, the goal of cutting federal expenditures in Fiscal Year 1975 to below \$300 billion is essential 1) as a symbol of government determination to hold down inflation; 2) as a means of getting Congress to reconsider program priorities and formulate standards for evaluating them; and 3) as a basis for, and contribution to, relaxation of tensions in credit markets. A tight rein on expenditure growth must continue in Fiscal Year 1976.

Second, tax relief for low and moderate income families who have suffered most from inflation must be provided quickly, through a \$100 tax credit or similar measure. (Other recommendations for tax changes are cited below. Revenue losses from tax relief--but not from reduced receipts caused by economic slowdown--should be recouped to the greatest extent possible by offsetting tax increases.)

Third, the federal government should fund (within the \$300 billion expenditure limit) a temporary but substantial public service employment program, phased in as unemployment rises above 6 percent in local labor markets.

Fourth, much greater emphasis must be placed on conservation of gas and petroleum, in the short run to reduce reliance on imported fuels (for balance of payments and security reasons, as well as to put downward pressure on international oil prices) and in the longer run as part of an overall program for matching supply and demand for energy. Specifically, consideration should be given to variable tariffs on imported oil, and to gradually relaxing ceilings on domestic oil and gas prices. In this context, removal of depletion allowances and enactment of the windfall profits tax makes sense, for equity as well as revenue reasons.

Fifth, the Council on Price and Wage Stability should have subpoena powers, as well as the power to delay wage settlement and price increases for ninety days in major industries. The Council may have to reestablish guidelines for wage increases and profit margins to administer such a program equitably. The Council is the logical body to publicize the direct link between restrictive practices, productivity and incomes.

Sixth, measures should be taken to reinforce confidence in, and the performance of, banks and thrift institutions. Such measures should include: 1) supervisory insistence on gradually achieving a strengthened equity base and an asset/liability mix less sensitive to interest rate fluctuations; 2) greatly improved information on, and reserves against, banks' Eurocurrency and foreign exchange positions; 3) raising ceilings on consumer deposit rates, and encouragement of variable rate mortgages.

Seventh, while credit allocation should be avoided, measures are needed to restore the capacity of capital markets to finance investment. Holding down direct government borrowing requirements will help, but much

tighter surveillance is needed on claims originated by federally sponsored agencies and under federal loan guarantee programs. Special help may well have to be provided to utilities facing serious financial problems. Tax incentives to leveraging should be removed, and equity investment made more attractive.

In addition to the immediate program, serious work should begin on the following types of structural changes.

First, eliminate government practices and laws that create significant inefficiencies and impede competition. Professor Houthakker and others have presented lists of sacred cows to be sacrificed.

Second, tax changes should include among others:

- 1) shift social security financing to an income tax surcharge from the regressive payroll tax.
- 2) depreciation allowances should be increased by permitting use of replacement values in a period of inflation. Similar offsets should be devised to eliminate the tax consequences of inventory valuation adjustments.
- 3) income tax schedules should be revised to eliminate shifts to higher brackets caused solely by inflation.
- 4) as a start, 20 percent, say, of dividends should be deductible as a corporate business expense. The effect would be to increase cash flow, earnings and the market value of equities. Households and pension funds would gain an immediate increase in asset values. Most important, this change would begin

to remove the present disincentive to equity (as contrasted with debt) financing, and thus help put the nation's financial and commercial businesses on a sounder (less leveraged) capital base.

5) higher taxes on preference income, capital gains at death.

Third, there should be another try at some form of negative income tax to replace welfare and related payments.

Fourth, dedicated revenues, particularly the highway trust fund, should be carefully reexamined, along with other continuing appropriations.

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