SECURITY - AT WHAT PRICE?

Remarks by
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A speech in this bicentennial year of our independence is usually devoted to recounting our achievements of the past. And, indeed, there is very much to be proud of. We have evolved a political system which allows unprecedented freedom and we have developed an economic system which has provided us with a standard of living matched by few other countries in the world. (Chart I) Unfortunately the achievements of the past are not necessarily indicative of achievements in the future. Our activities in the past thirty years plant seeds of doubt as to the maintenance of our continued economic expansion and the maintenance of individual freedom. As one who is interested in economic and financial progress, I see changes in institutional behavior which may become the cause of radical curtailment of this progress.

Recently we have been told that the old laws of economics are no longer valid, that we cannot expect the economy to function as it has in the past, that policy actions cannot produce the same results, and radical new approaches must be adopted to deal with our problems. Since the so-called laws of economics are simply a description of human behavior within some institutional structure, we should expect any changes to manifest themselves either in some difference in people's behavior or in the institutions which set limits to their responses. There seems to be no evidence whatsoever that people react differently to given economic stimuli, but one can observe radical changes in the character of our economic and political institutions. And perhaps the most outstanding is the persistent expansion of the Government sector and the composition of Government spending.

I will not be so presumptuous as to debate philosophical issues surrounding the size of the Government, but I believe that the consequences of the financing of the continuously growing Governmental activity are misunderstood. That the Government has grown and that the composition of its spending has changed can be easily seen in Chart II, III and Table I.

The major causes of Government growth are readily identifiable and are related to our quest for even greater security. I cannot pass judgement whether this quest is justified -- that is a matter for the political process to decide. But I can point out that this quest has also involved a method of financing of Government expenditures which, in my opinion, is inconsistent with the goals themselves and with the survival of our economic and political institutions.

The existence of a Government implies that society has decided that security can be obtained better by using collective means. Security must be interpreted broadly and includes such things as national security and security of individual rights, including property rights. There is virtually no question that Governmental guarantees of these are desired and that the society is willing to pay for them.

In the past thirty years, however, we have added to the list of our various demands the desire for security of income. This again has taken many diverse forms. Income security consists of such various goals as the avoidance of economic fluctuations, guaranteeing a minimum income, providing higher income opportunities through free education and training, and avoiding the loss of income through health and social insurance. That this has been the trend in our Governmental activity can be seen in Table I. What is not clear, however, is whether the society is willing to pay for these services, or, indeed, that it has been given the opportunity to make that judgement.

One can see clearly that Governmental spending which is designed to maintain or redistribute income has been growing rapidly since World War II, particularly since the early 1960's. While these programs have apparently been approved by the majority of our society, it is my contention that we have not been adequately informed as to the costs of these programs and have not <u>explicitly</u> approved their financial support. And it is this lack of <u>explicit</u> approval that generates problems to which I would like to address myself.

Let us now consider the process by which security can be financed. Any one of us can acquire security by two processes and by these two processes alone: we can save and use resources at a time of need, or we can buy insurance. Provision of security means that some resources have to be withdrawn from consumption stream and saved until such time that security payments have to be made. By saving, an individual denies himself consumption at the present time in order to be able to consume when income declines or disappears. When we buy insurance, we give up current consumption in order to pay premiums and we receive resources in the form of insurance payments when the need arises. To provide security resources must be withdrawn from the consumption stream to be available for future payments. This is true of all societies at all times.

When we choose the Government as a medium in providing such insurance, the process described above must take place. In order to make insurance payments, the Government must be able to provide resources for those who receive them. This can be done, as in private cases, by the Government acquiring and saving resources and disbursing them at some future time. Or through current redistribution of resources to those whose income has been guaranteed from the rest of the society.

One way to perform such transfer of resources is to tax some individuals and pay others. When Government expenditures are financed through an increase in taxes, the cost is readily visible and readily felt by all of the taxpayers in the society. The political process then guarantees that the services demanded are willingly paid for and that there are no unforeseen economic repercussions.

Another way for the Government to increase spending is to incur a deficit financed by the sale of Government securities to private individuals. Resources are then currently transferred from bond buyers to those who receive Government payments. Lenders willingly give up current consumption to get greater wealth in the future; the fact that the goods they are sacrificing are being redistributed by the Government does not concern them. And society as a whole realizes, or should realize, that the debt will ultimately be repaid through higher taxes. It should also recognize that the way in which the private sector is persuaded to give up control of more resources to the public sector is through the higher interest rates which increased Government borrowing entails. This method may not have the prior approval of the electorate, but if objections to higher interest rates are not expressed through the political process, it implies at least a tacit approval.

If, on the other hand, demands for security persist and are not accompanied by a willingness to make immediate payment in the form of higher taxes or higher interest rates, there is a third method of financing which produces repercussions that extend beyond the readily identifiable costs. What is worse, it enables our elected representatives to produce the illusion that such security can be obtained at no cost at all.

Again, the sale of Government securities to the private sector will cause interest rates to rise. If at the same time there are pressures to maintain low interest rates (as an instrument of assuring the income security of, say, suppliers and buyers of housing), the central bank must buy the bonds from the private sector. Such a purchase will reduce interest rates from what they would have been otherwise in the short run but will increase, dollar for dollar, the actual and potential reserves of the banking system. The banks, given excess reserves, will increase their loans and investments and thus will increase the money stock.

Thus, in effect, additional Government expenditures have been financed through the creation of money. The Government enters the market with its acquired funds and purchases resources that are then transferred to its selected recipients. But, still, the donors in the society must be induced to give up those resources, and the inducement comes, with about a two year lag, by way of an increase in the price level which makes their money worth less in real terms than they had anticipated. A continuation of this method of financing produces inflation. Some of the evidence can be observed in Chart IV.

The upshot of this discussion is that, irrespective of the method of financing, Government services can be provided only by a transfer of resources. But the currently favored method of this transfer -- financing through creation of money -- temporarily masks the costs involved. This induces a demand for and approval of additional Government services which might very well not be forthcoming if those costs were made clear and explicit.

It may be argued, but only by those with a basic contempt for the public, that so long as payment is made ultimately, there is no harm in a bit of deception when the services provided meet with society's approval. This is precisely where the damage is done. Inflation produces long term consequences which are significantly more serious than the costs of either a current increase in taxes or in interest rates. And any choice based on incomplete information is not likely to reflect the real wishes of the society.

In the first place, inflation, given a structure of progressive income taxes, increases Government revenue without an explicit increase in the tax rate. It provides the means of extracting from taxpayers a larger proportion of their income without their agreement. (Chart V). Secondly, the expected rate of inflation is a primary determinant of long term interest rates; when the belief that accelerated inflation will continue becomes widespread, interest rates will rise. Third, unanticipated inflation redistributes wealth from monetary creditors to debtors. This occurs as creditors receive payment in reduced purchasing power and debtors repay in decreased real value. One can see that this wealth redistribution is arbitrary and totally unrelated to rewards for productivity, and thus undermines the incentive for productive efficiency.

Fourth, greater uncertainty as to the future course of the price level reduces willingness to enter into long term contracts with the consequent discouragement of long term investment. This is illustrated in Table II.

Shorter debt maturities increase the risks for long term investors and reduce investment in long term projects. The recently debated so-called capital shortage may well be a result of greater inflationary uncertainty. Fifth, inflation increases the costs of holding and using money by reducing the purchasing power of money stocks. Money is a productive resource which facilitates transactions. A decrease in its use necessarily means that we move closer to barter. And I don't have to tell you what this does to the standard of living. We have excellent examples of this process in the German experiences after World Wars I and II and more recently in several South American countries.

Finally, in this country inflations have typically not been tolerated for long without periodic efforts being made to stop them by reducing the rate of growth of money. In every case where these reductions have been sharp, a recession has developed, involving highly undesirable human suffering and loss of output.

What all of this amounts to is that our attempts at ever greater security, which have not been matched by our explicit willingness to pay for it, have of necessity resulted in payment which has brought with it additional economic malallocations. These disturbances have had long lasting and sometimes irreversible effects.

Now let us see whether we have derived any significant benefits from our pursuit of additional security. Have we reduced income fluctuations? We have had an accelerating inflation and six recessions in the past 28 years.

This is no less frequent an occurrence of fluctuations than we have experienced before the Government undertook its diverse activities aimed at greater income security.

Have we, through all of our income transfer policies equalized the distribution of income? Table III indicates that such reallocation has been virtually insignificant.

Where do we stand then? It seems that many of our desires for income security have not materialized. But the repercussions of the financing of these Government expenditures have created grave problems. How long would we tolerate an inevitable decline in the growth of the standard of living? How long are we going to tolerate an arbitrary redistribution of income? How long are we going to tolerate recurring recessions? Is not our individual freedom even now being threatened as the blame for these phenomena is placed everywhere but where it should be?

And interesting enough, these problems are not caused fundamentally by our demands for additional security, nor by the level of Government activity, but simply by a method of financing which has fooled the electorate into choosing those services and has produced inflation with all the ensuing deterioration of our economic and political system. Are we going to give up 200 years of hard work for an illusion of getting something for nothing?