WOULD A TAX CUT BE INFLATIONARY?

Address by
Lawrence K. Roos
President
Federal Reserve Bank of St. Louis

Before the
Financial Analysts Society of South Florida

November 19, 1980

Two weeks ago, the voters of this Nation chose a new President and significantly altered the alignment of power in the Congress. There can be no doubt that a major factor contributing to these election results was the high priority that Americans place on reducing the inflation that has taken such a toll for the past twenty years. Just as certainly, there is a widespread desire to change the direction in which our economy has moved in the past, and to make the 1980s a decade of greater economic growth, increased productivity and employment, and reduced government intrusion into the affairs of all citizens.

One of the first economic proposals announced by the incoming administration to achieve these goals is a reduction in federal taxes. Such a reduction is intended to stimulate productivity and capital formation, thereby ultimately to exert a moderating influence on inflation as well.

Now, I enthusiastically support the concept of responsible tax reduction and would heartily welcome any action that would reduce inflation. As an official of the Federal Reserve, I have consistently maintained that continuing inflation poses a deadly danger, not only to the economic stability of our Nation, but ultimately to the very survival of the social and political institutions upon which our society is structured. Therefore, I wish that I could tell you that the tax cuts as proposed would be certain to have the desired effects claimed by their proponents. Unfortunately, this is simply not so. For, unless the proposed tax reductions are accompanied by similar reductions in federal spending, lower taxes will have virtually no effect on output and productivity growth. Furthermore, unless they are accompanied by a phased gradual reduction in the rate at which money is created, lower taxes will have virtually no effect on inflation. Even worse, unless the proposed tax reductions are accompanied by commensurate reductions in federal government spending, they may easily result in increased rates of money growth and even higher inflation than we are currently experiencing.

In my remarks this evening, I would like to explain why I believe that tax cuts alone are not the answer to our economic problems; why, by themselves, they will neither increase output nor reduce inflation. I hope to demonstrate to you--and to convince

you--that tax cuts must be accompanied by both reduced government spending and reduced rates of money growth if we are to be successful in changing the direction of the American economy in the next few years.

I would like to begin with the simple, but fundamentally accurate, observation that the core rate of inflation, the part of inflation that persists year-after-year throughout the various stages of the business cycle, is determined by two basic factors:

1. the available supply of goods and services; and,
2. the amount of money that people have available to spend on these goods and services.

When the supply of goods and services remains constant and the supply of money and credit is increased, prices of goods and services are bid up, and inflation results. Conversely, when the supply of goods and services is expanded and the money supply is kept constant or reduced, inflation declines. Therefore, a determination of the likely impacts of tax reductions on our economy requires determining their effects on either the supply of goods and services or the availability of money and credit.

What impact could tax reductions be expected to have on the available supply of goods and services? Much has been written and debated about "supply-side" economics, the allegedly "new" discovery that tax reductions will encourage people to work and to save more, firms to invest and produce more, and therefore, the nation over time to expand the growth of available goods and services. The simple common-sense notion underlying this claim is merely that tax reductions result in increases in the public's after-tax real income and that individuals will respond to these increases in predictable ways. It is this impact, and really nothing more complex, that would encourage more saving and investment.

Now, I am somewhat skeptical, for a variety of reasons, of the more extravagant claims emanating from the advocates of supply-side economics. The Federal Reserve Bank of St. Louis cohosted a conference on supply-side economic policy just a few weeks ago. It was attended by more than one hundred economists, business leaders, and government officials. The consensus reached by participants, after a thorough analysis of

supply-side impacts, was that tax reductions would marginally increase the supply of labor, would generate slightly higher levels of saving and investment, and would produce small increases in capital formation; but that these effects would, at best, be minimal. We simply cannot expect that tax reductions alone will be sufficient to finance a "free lunch" for our Nation.

We should not be surprised by this conclusion. It is clear that tax reductions, unaccompanied by reductions in federal spending, produce other less desirable side-effects that would, in general, eliminate the hoped-for supply-side boost to the economy. First, reductions in taxes, by themselves, would increase, at least initially, the federal deficit. Currently the "best" estimates of the existing deficit, without any tax cut, are in excess of $30 billion. Any increase in that deficit would force the government to borrow even more funds in the nation's credit markets, and this, in turn, would cause interest rates to rise as the government bids even more aggressively for additional credit. At least initially, the higher interest rates would tend to reduce some private investment and channel any additional private resources generated by the tax reductions right back to the government. In other words, the federal government would simply be borrowing back through the credit markets the funds it released as tax reductions. Consequently the private sector would be left with no more resources than it originally had.

Moreover, the public is unlikely to be fooled for long by this "bait and switch" approach to economic policy. Reducing taxes now (the bait) and selling more government bonds to finance the larger deficit (the switch) would not, in any fundamental manner, reduce taxes. Increased government deficits now merely mean that taxes would have to be increased at some time in the future to repay the additional borrowings. Consequently, it is difficult to see how tax reductions alone can increase in any significant way our after-tax real income as a Nation.

The story becomes even worse, however, when we contemplate the potentially adverse impact of tax reductions on monetary policy and the growth of the money supply. In the past, a rise in interest rates associated with increases in the federal deficit

usually has resulted in accelerated money growth, because the Federal Reserve usually "monetizes" some of the additional federal debt sold in financial markets. It doesn't really matter why this occurs. It may be, as I have repeatedly argued in the past, that the Federal Reserve has done this by accident as a result of using faulty operating procedures; or because it focused attention on the behavior of interest rates rather than directly on the behavior of the monetary aggregates, or because it simply misjudged increased demands for credit as increased demands for money.

Or it may be, as others have argued, that various "pressures" generated by the Congress, by the President, by the financial community, or by others have influenced the Federal Reserve to attempt to retard the upward movement of interest rates because this rise was judged to be "politically unacceptable." Whatever the reason, when interest rates were rising in the past, the money supply has expanded as the Federal Reserve purchased increased amounts of government securities in an attempt to resist the rise. Of course, the resulting increase in the growth of the money supply inevitably led to an increase in the rate of inflation. And, not surprisingly, once inflationary expectations were raised, interest rates rose despite the Federal Reserve's efforts to the contrary. Thus, attempts to hold down interest rates by increasing the rate of money growth have been futile. Yet, such attempts have occurred over and over again during the past twenty years as the Federal Reserve has tried to lean against the very same movements in interest rates that are likely to result from the tax reduction now being considered. As a consequence, the resulting inflation has, if anything, reduced the Nation's real income, not increased it.

The story would be significantly different, however, if the proposed tax reductions were accompanied by dollar-for-dollar reductions in government expenditures. Under such circumstances, since there would be no increase in the deficit, real resources would be released from the government sector to the private sector, and the additional savings would flow directly to private investment and capital formation. Since these are the uses that are likely to increase productivity and increase the rate of growth of goods and services in the future, only then would full supply-side advantages be obtained.

It should also be clear that a tandem reduction in taxes and government expenditures would provide an opportunity for the Nation's monetary authorities to conduct a long-term policy designed to reduce inflation. They would be able to gradually reduce the growth of money without having to engage in short-run operations for the purpose of retarding movements in interest rates. Because tax reductions accompanied by federal spending reductions do not produce larger deficits, there would be no upward pressure on interest rates and, consequently, no particular reason for the Federal Reserve to stray from its publicly announced long-range targets for money growth.

To summarize my position, I would reiterate that a reduction in income taxes without a commensurate reduction of government spending would be unlikely to produce any of the benefits that are being widely proclaimed on its behalf; on the contrary, it is easily conceivable that the associated increase in the federal deficit could result, via its effect on interest rates, in greater growth in the Nation's money stock and accelerated inflation. On the other hand, a reduction in taxes coupled with a proportionate reduction in government spending would likely result, not only in an increase in productivity and the supply of goods and services, but would also reduce the temptation for the Federal Reserve to wander from the only path available to us to reduce inflation--a gradual phased reduction in the growth of money.

The lesson of the recent election should be clear to us all. Citizens of this Nation are fearful of the dangers of accelerating inflation and have given their mandate to the incoming administration to take strong affirmative action in dealing with the problem--even if it means incurring a certain amount of temporary economic discomfort in order to restore the economic stability necessary for permanent future prosperity.

The ultimate choice is for us as individuals to make. But it must be an informed choice, a carefully reasoned choice with full knowledge of the alternatives available. I believe that we have a clear choice. We can tolerate inflation and witness the decline of America as a great economic power . . . or we can demonstrate the determination both to eliminate inflation and to restore the foundation of stability and growth so

necessary for our national survival. The choice is between tax reductions alone, or tax reductions accompanied by meaningful reductions in the levels of government spending. It is my hope and prayer that we choose wisely.