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Statement by

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before the

Committee on Finance

United States Senate

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Mr. Chairman, I am pleased to participate in the Finance Committee's hearings on tax legislation. While decisions regarding taxation fall outside the province of the Federal Reserve, the System is certainly not a disinterested observer. I hope that my appearance today will contribute to the development of a coherent set of public policies to deal equitably and effectively with the economic problems confronting the nation.

Economic achievements and concerns

The past three-and-one-half years of economic expansion have brought substantial gains in production and employment. This may be seen in the first of the attached charts. Real gross national product has increased more than 18 per cent, and total employment has risen by almost 10-1/2 million. A larger proportion of our people have jobs today than at any time in the nation's history.

Even so, unemployment remains unacceptably high among some segments of the population--especially certain minority groups and youth. And there are areas of the country that, owing to their particular industrial mixes or to other factors, have lagged noticeably in economic recovery. We must make certain that all of our people have an opportunity to achieve a greater measure of prosperity. But in setting monetary and fiscal policy we must also recognize that many of these lingering elements of weakness in the economy reflect structural problems that will not be solved through rising levels of aggregate demand alone.

Indeed, while there is a clear need to maintain the upward momentum of economic activity, we must be increasingly alert to the need to avoid excessively rapid growth. It is desirable that the pace of expansion moderate as a business cycle upswing matures and the economy approaches high levels of utilization of labor and industrial capacity. At times in the past aggregate demand overshoot the level at which these resource constraints became significant, and inflationary pressures mounted dramatically. We can not run the risk of repeating that mistake.

Inflation is the pre-eminent economic concern of our people today, and the greatest threat to the vitality of the current expansion. The advance in prices has accelerated sharply this year, averaging almost 10 per cent, at an annual rate, at the consumer level. Food prices have been a major element in this step-up in inflation. While there have been signs recently of improvement in that sector, other prices are continuing to rise briskly, as may be seen in Chart 2. Across the economy, cost pressures have remained intense, reflecting in part the effects of a rise in the minimum wage and of increased employer contributions for social security and unemployment insurance. At the same time, the depreciation of the dollar in international exchange markets has raised import prices and reduced the competitive pressures on prices of domestically produced goods.

### Setting the dimensions of the tax cut

Under the circumstances, Congress must weigh with great care the size and composition of its tax program. A tax cut certainly should provide no more stimulus than is necessary to sustain moderate economic expansion; anything more could jeopardize our chances of restraining inflation. It should also be structured in a way that recognizes that our tax system exerts a powerful influence on our economy through the incentives it provides for work and for capital formation. The Congress can take a significant step toward the enhancement of our nation's economic welfare by paying heed to these "supply-side" effects. In the remainder of my statement, I want to discuss briefly both the size and shape of a desirable tax cut today.

It is my judgment that a tax reduction in the vicinity of \$15 billion being discussed by Congress would be appropriate for the coming calendar year. Despite some bumpiness related to strikes and weather this past winter, the recent pace of economic expansion has on balance been satisfactory. However, available indicators of future economic trends suggest that, in the absence of some fiscal adjustment, private demands might well prove insufficient to sustain growth that is strong enough to prevent the unemployment rate from rising in the next year.

As illustrated in Chart 3, consumer buying sentiment remains generally favorable, but the savings rate is already at a fairly low

level and debt repayment burdens are at a record high. Consequently, consumption expenditures, which up to now have been a dynamic factor in the expansion, are likely to provide little impetus to activity. Housing starts (shown in Chart 4) have remained at a high level thus far this year; given the tighter conditions that have developed in the mortgage market, however, it is probable that residential construction activity will begin to taper off in upcoming months. Businessmen meanwhile remain hesitant about undertaking major capacity-expanding outlays for plant and equipment. Recent data on orders for machinery and other capital goods have been on the weak side, as may be seen in Chart 5, and these suggest that real business fixed investment may grow rather sluggishly over the next few quarters.

Against this backdrop, a reduction in Federal taxes next year would provide timely support to spendable income. It must be remembered that without a tax cut we would actually be facing a substantial tax increase in 1979. Mandated social security tax increases alone will boost Federal revenues by about \$8 billion; in addition, taxes for individuals will be increased another \$8 billion or more by the interaction of inflation and the progressive income tax structure. As a result, a tax cut on the order of that embodied in the House-passed bill would serve only to neutralize the impact of these other revenue changes already in train.

Of course, it is also essential to consider the expenditure side of the budget ledger when determining the size of tax cut that can be afforded. If we are to have any real hope of containing inflationary pressures, it is imperative that the budget deficit be reduced from the \$50 billion level projected for the current fiscal year. Spending cuts of the dimension recommended recently by the Administration would permit reasonable progress toward the longer-range objective of restoring budgetary balance--even with a tax cut. A narrowing of the deficit to the \$40 billion area also would be consistent with sustained economic expansion and further sizable gains in employment.

Providing tax relief to the household sector

The next question is how a tax cut of the proper over-all size should be structured in order to make the maximum contribution to the achievement of the goals of full employment, price stability, and a sound dollar. The fact that there will be substantial contemporaneous increases in taxes on individuals suggests the desirability of allotting to this group a large share of the tax reduction. Rising prices of food and other necessities have strained the budgets of many households, and these hardships should not be intensified. In this respect, the distribution of the tax cuts between the household and corporate sectors implied by H.R. 13511 appears reasonable. However, I have some doubts regarding the particular devices employed in delivering this tax relief.

As I noted earlier, a significant portion of the tax cuts would serve only to offset the revenue impacts of scheduled social security tax increases. It might reasonably be asked, I think, whether it would not be more desirable simply to defer the 1979 social security tax changes. This course of action would have some significant advantages. Besides bolstering disposable personal income, it would avert another inflationary impulse to the structure of labor costs. The Board's staff has estimated that the scheduled increase in employer contributions to social security would add roughly one-half percentage point to inflation next year.

A one-year deferral of the further tax increases dictated by the Social Security Amendments of 1977 would not place undue strain on the resources of the trust funds. Nevertheless, a deferral should be enacted only with an explicit and urgent commitment to action that deals realistically with the remaining long-range problems of the Social Security System. Last year's legislation did ensure the System's financial viability by making much needed corrections of the benefit computation formula and by increasing contributions. But the people of this country are faced with the prospect of a rapidly growing financial burden, and a social security tax that is both inflationary and regressive. I would recommend that Congress undertake a comprehensive study of the Social Security System so that needed legislation could be enacted next year.

The need to increase business investment

In considering the corporate and capital gains tax provisions of H.R. 13511, I would hope that this Committee would focus its attention particularly on how the proposed cuts would contribute to the enhancement of business fixed investment. The performance of capital spending in this economic expansion has been most unsatisfactory. Real business fixed investment reattained its previous peak level only in the second quarter of this year--much later than has been the case in other cyclical upswings. Furthermore, the growth of the nation's capital stock has not kept pace with the increases in its work force. Indeed, as may be seen in Chart 6, throughout the 1970s the ratio of capital stock to labor has fallen ever shorter of its earlier growth trend line, and this undoubtedly has been a significant factor in the slower growth of productivity we have experienced over this period.

Capital accumulation is a critical ingredient in the long-range growth of labor productivity and the raising of living standards. To compensate for the neglect of recent years, as well as to accommodate to the reality of scarcer and more expensive energy, a larger share of GNP must now be devoted to the expansion and modernization of the nation's capital stock. It will not be enough simply to reach the investment proportion of 10½ to 11 per cent that has been characteristic of past periods of prosperity and low unemployment. In my

opinion, the nation must set an ambitious goal of, say, 12 per cent of GNP for an extended period--a level that would foster more rapid improvement in productivity and faster economic growth.

Some shortcomings of the capital gains and corporate income tax cuts

The capital gains and corporate income tax cuts in the House bill should provide some impetus to business capital formation and represent moves in the right direction. What must be considered is whether they are the most effective measures that might be taken at this time. I have some reservations on this score.

There is, as you know, considerable controversy about the effects of a capital gains tax cut on investment and on Federal revenues. This is not surprising. A change in capital gains treatment would work its influence through a complex and uncertain set of channels. In assessing the impact on business capital formation, one must contend with the fact that the tax change would affect investment by both households and businesses in all sorts of assets, ranging from diamonds to real estate. How much effect the tax cut would have on the price of corporate stock and thus on the cost and availability of equity capital is unclear; and how this would translate into acquisition of new plant and equipment is a further uncertainty.

Still, a reduction in capital gains taxes does have its attractions. It would, for example, bring some relief to investors

who are confronted with very high effective real tax rates--ofttimes exceeding 100 per cent--because their cost bases in calculating capital gains do not rise to reflect inflation. It would also benefit young, emerging firms which have little current income and thus are not in a position to benefit from other changes in business taxes; lower capital gains taxes would encourage equity investment in such enterprises. All things considered, I would conclude that some cut in capital gains taxes would be appropriate, but I would not assign it as high a priority as other tax actions whose impacts on investment are more direct.

My reservation about the capital gains provisions of the House bill extends to the corporate tax changes as well. Again, insofar as incentives for business investment are concerned, the bill uses a shotgun approach rather than a rifle. It does provide for a phased liberalization of the investment tax credit, with an estimated first year impact of \$500 million, but the bulk of the corporate tax reduction occurs through a lowering of the rate structure. Although lower tax rates would improve after-tax profits, the linkage between this improvement in cash flow and spending on new plant and equipment is a loose one. The additional cash might be channeled into any of a number of uses--including the acquisition of other firms, the purchase of securities, or an increase in dividends. It thus seems

quite likely that a smaller gain in real investment would be achieved for a given dollar of tax revenue loss than would be the case with tax reductions that are linked directly to capital expenditures. While some cut in corporate tax rates is desirable--in part to enhance the profitability of businesses in less capital-intensive sectors such as services and finance--greater emphasis should be placed on other, more efficient, tax incentives for investment.

The advantages of more direct tax incentives for investment

Accelerated depreciation is a very efficient way to encourage investment. The tax benefits of faster depreciation accrue to a firm only after new plant and equipment has been put in place. In addition, enlarged depreciation allowances would redress--if in an indirect way--the serious drag on real corporate profitability that has occurred in recent years as inflation has caused replacement costs to exceed depreciation deductions by a wide margin.

Larger investment tax credits also provide direct incentives to capital formation and therefore are more efficient in stimulating investment than are corporate tax rate cuts. As with accelerated depreciation, a firm only receives a tax benefit if it acquires--or, under the current proposal, rehabilitates--a capital good. There are, however, likely to be differences in the cost-effectiveness of accelerated depreciation and investment credits--that is, in the degree

of investment stimulus per dollar of tax relief. These differences will hinge on some rather technical factors, among the most critical of which is the importance that businesses attach to the time-pattern of their income. When firms require very short pay-off periods for investment, accelerated depreciation will tend to be more cost-effective than tax credits in stimulating capital outlays. There unfortunately is no simple, direct way to measure the relevant variables; however, it is my judgment that at the present time, when changes affecting the environment in which firms operate seem to occur rapidly and unpredictably and businessmen are highly risk-averse, faster depreciation is likely to yield the greatest addition to investment per dollar of tax reduction.

A new challenge for fiscal policy-makers

I hope that the Committee will find the foregoing remarks helpful in its deliberations on the tax bill. The issues that it must address are many and complex. The Congress has made notable progress in the past few years in bringing better order to the nation's finances. The Congressional Budget Act has accomplished a great deal in providing for a more effective means for setting the over-all levels of revenues and expenditures consistent with the prospective strength of aggregate demand. But traditional demand management policies are not sufficient to solve many of the basic problems of the economy. Thus the Congress now faces a further challenge--to

structure its fiscal actions so as simultaneously to satisfy the criterion of equity, to minimize inflationary pressures, and to provide adequate incentive for growth and productivity enhancing capital formation. This is no small order, but conditions in the domestic and international economy demand that you aim for no less.

Chart 1

# OUTPUT, EMPLOYMENT, AND UNEMPLOYMENT

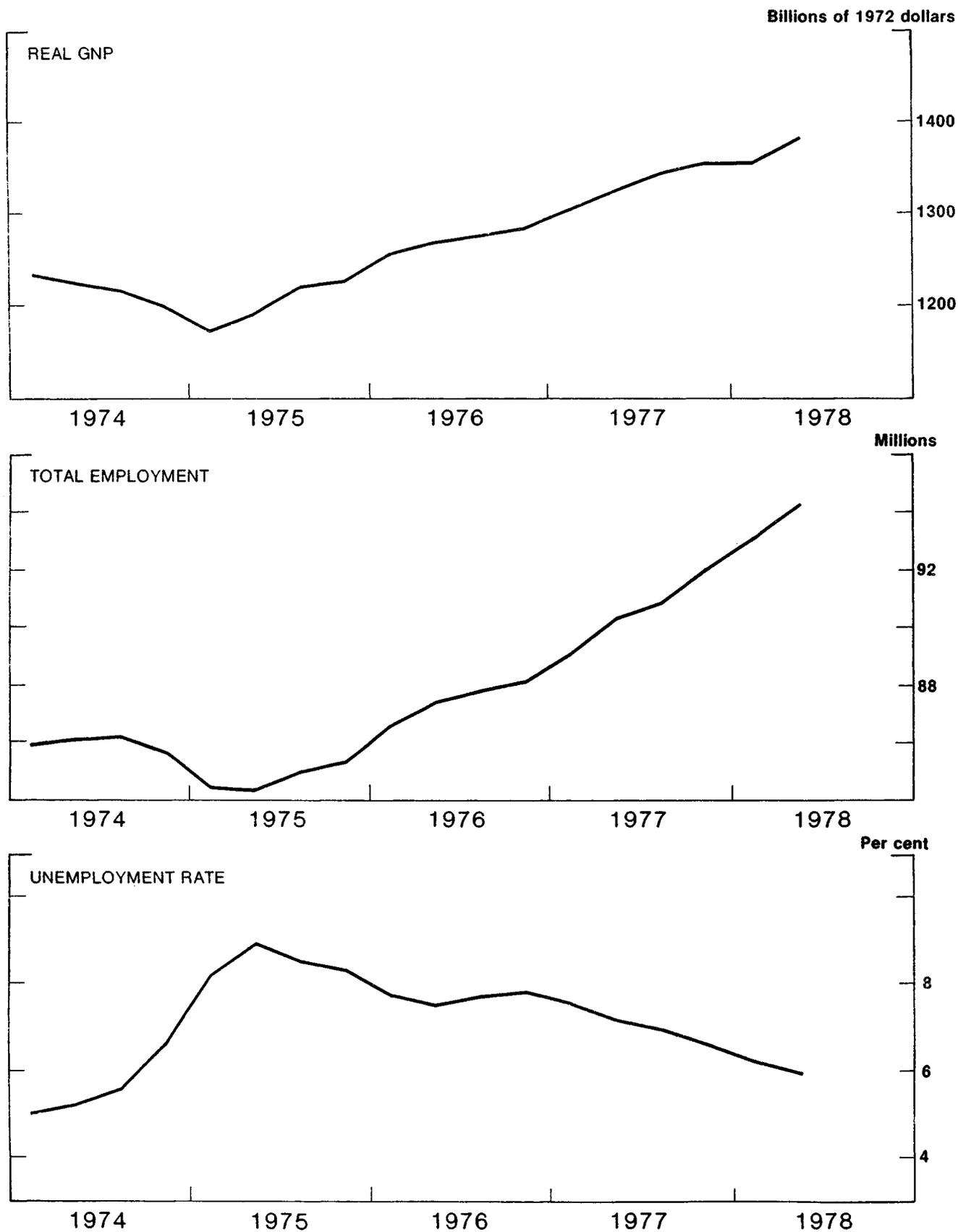


Chart 2

# MEASURES OF PRICES AND LABOR COSTS

Percentage change from previous period, annual rate

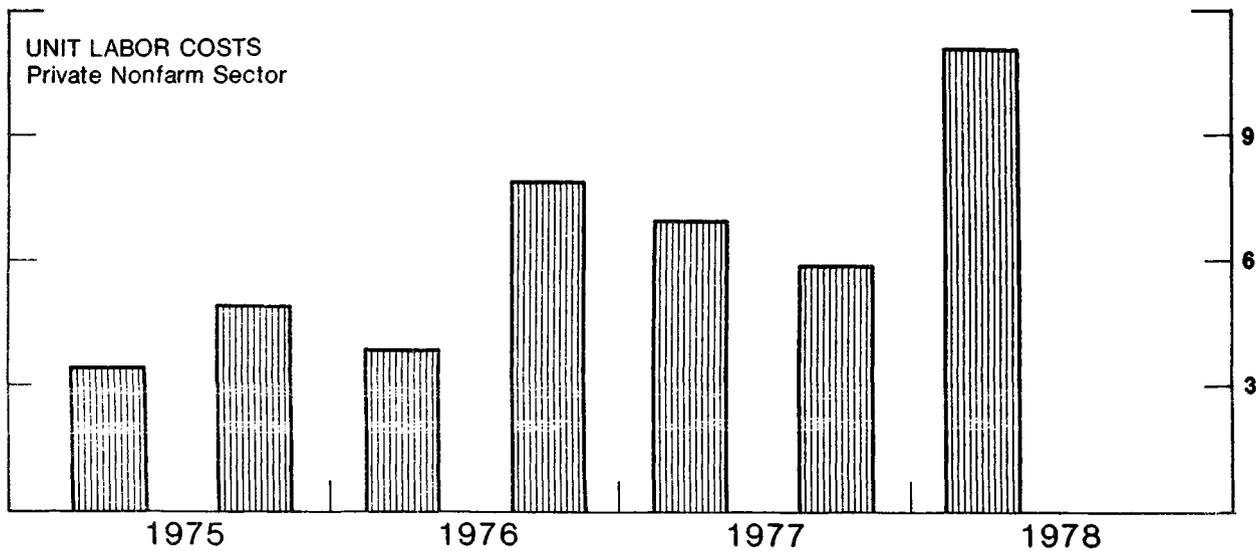
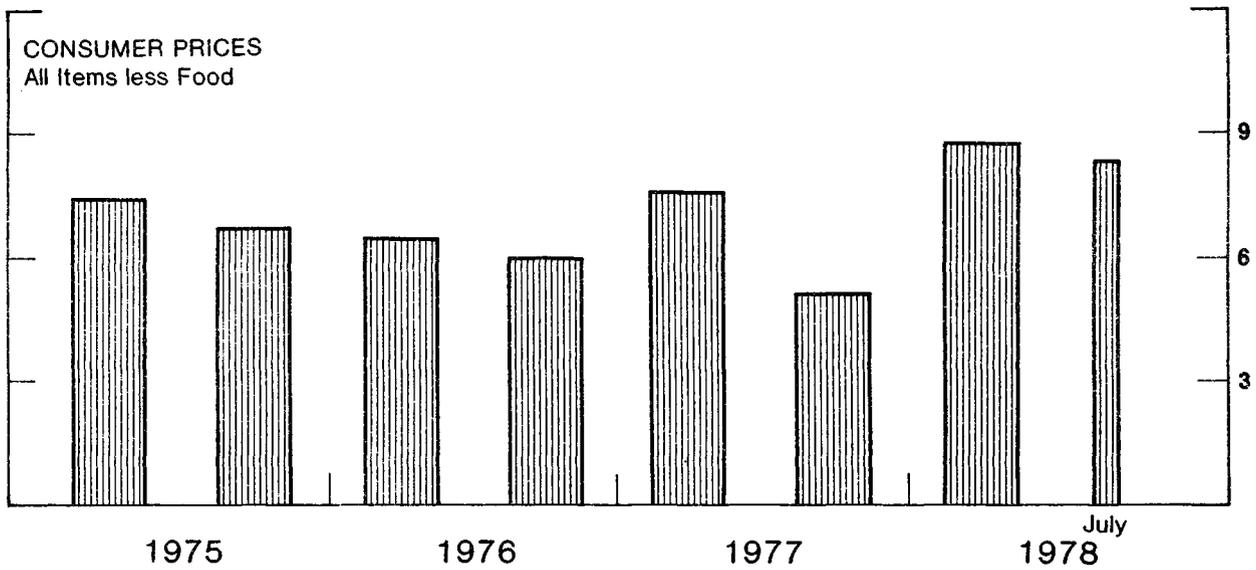
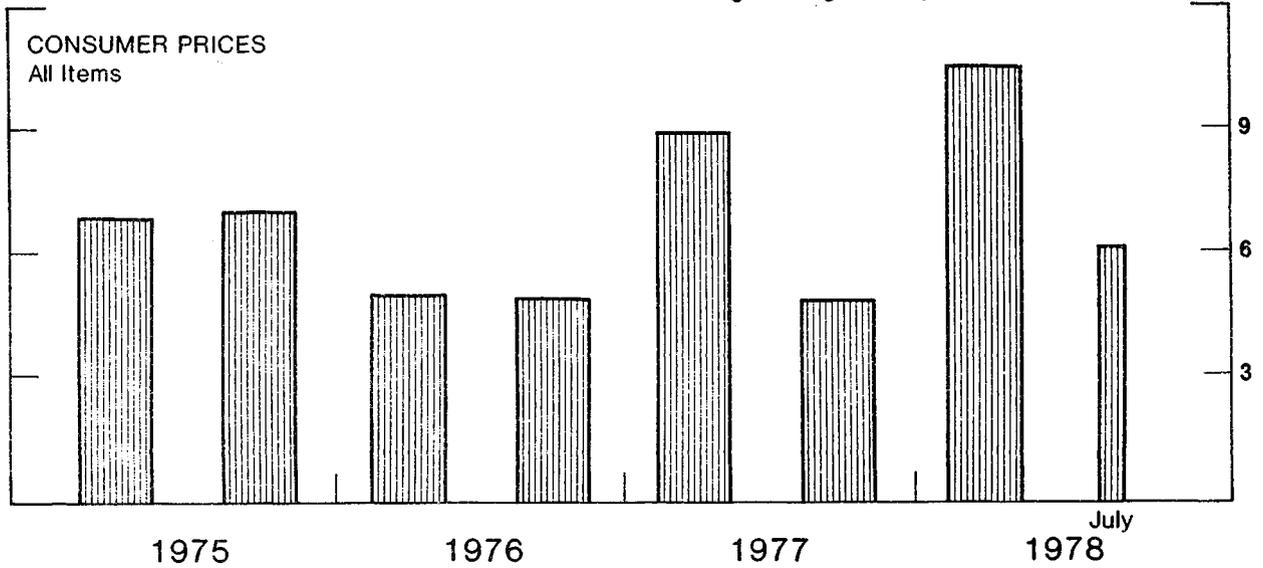


Chart 3

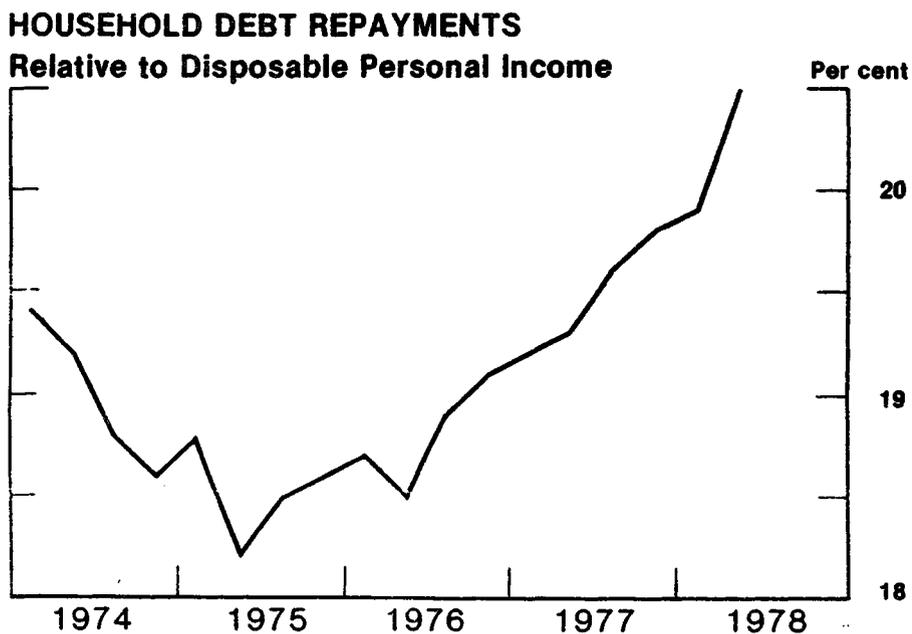
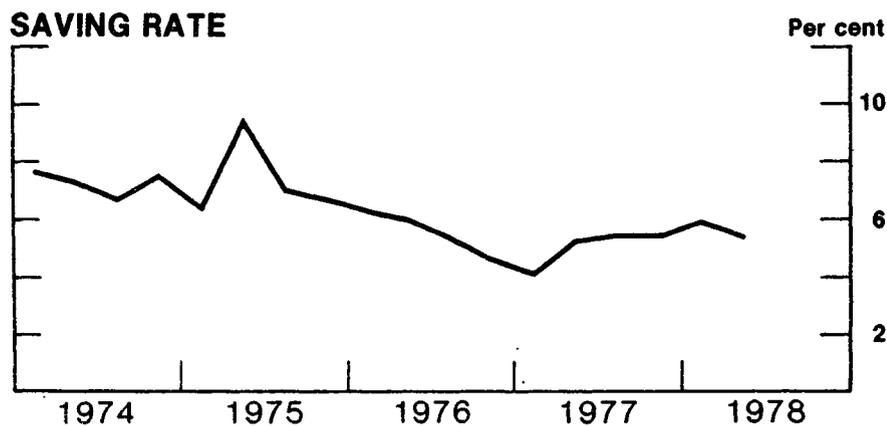
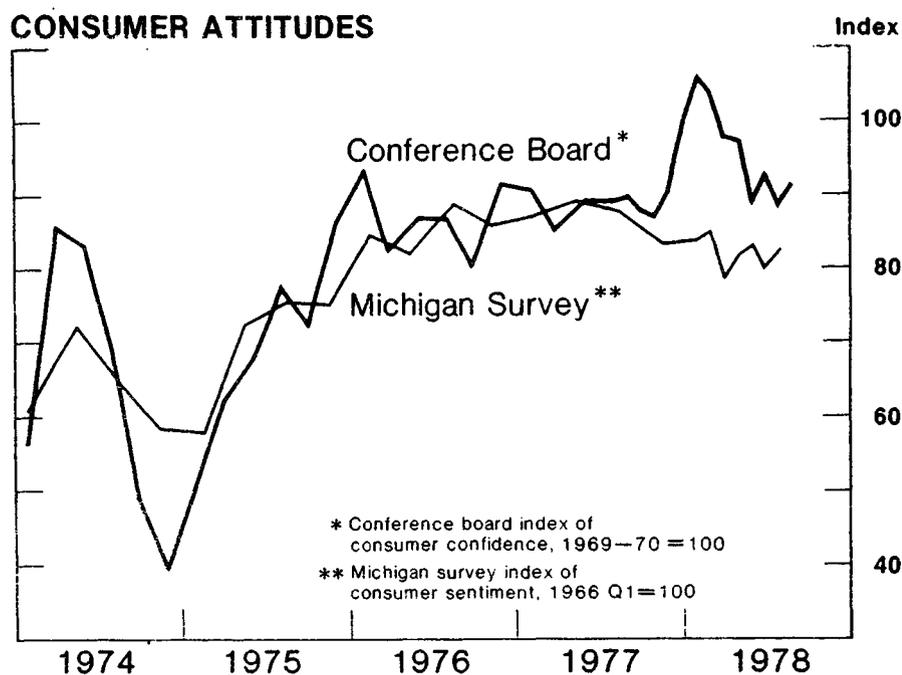
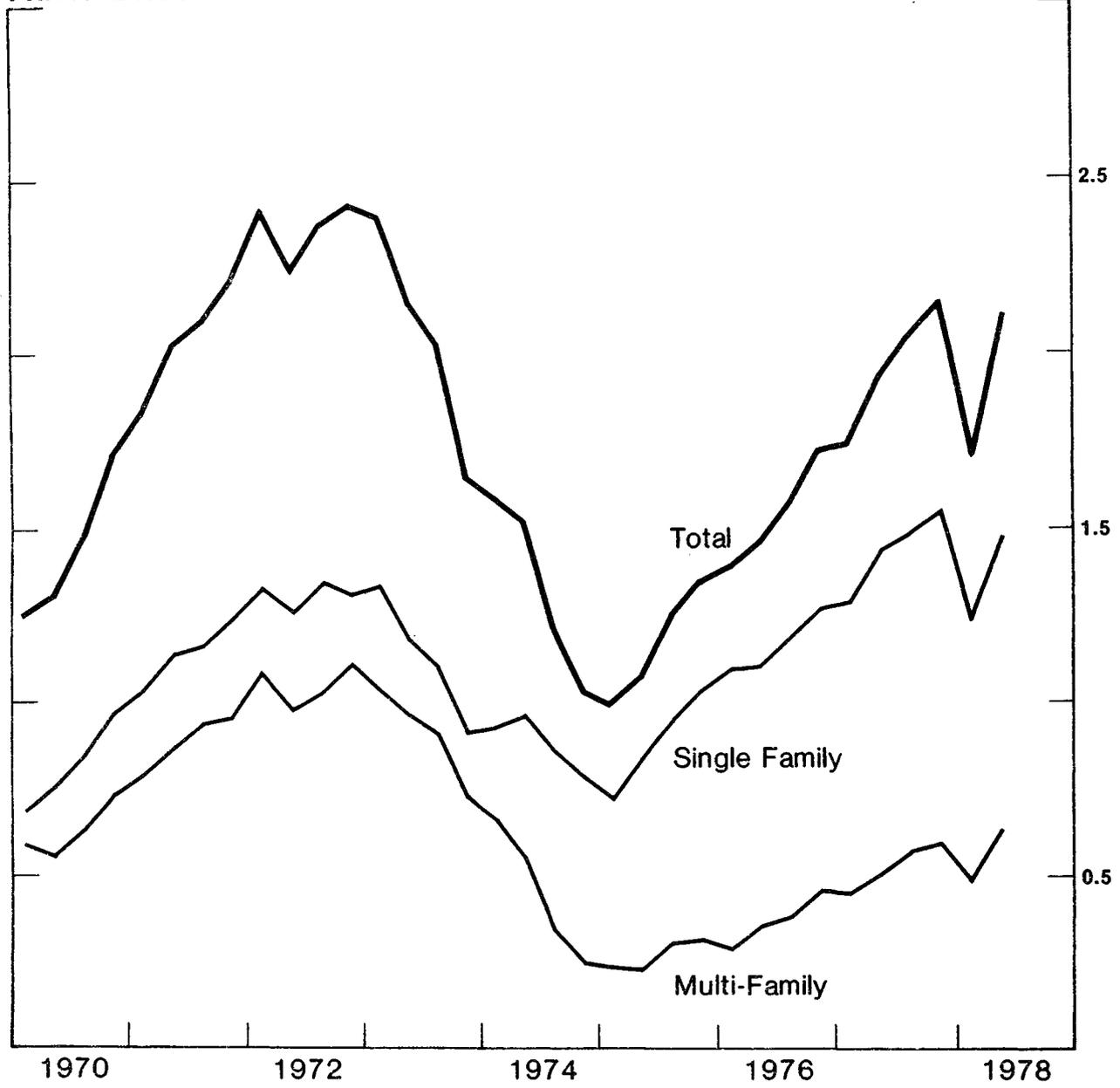


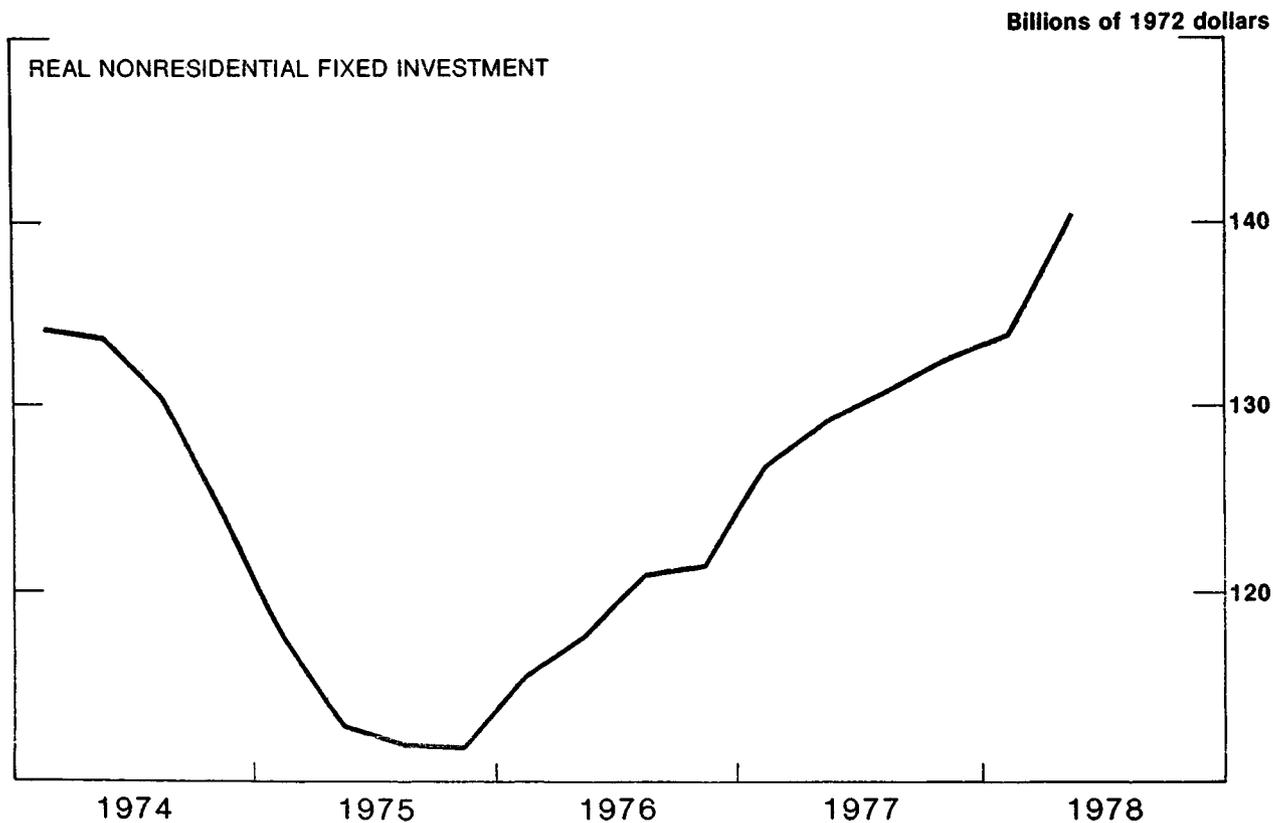
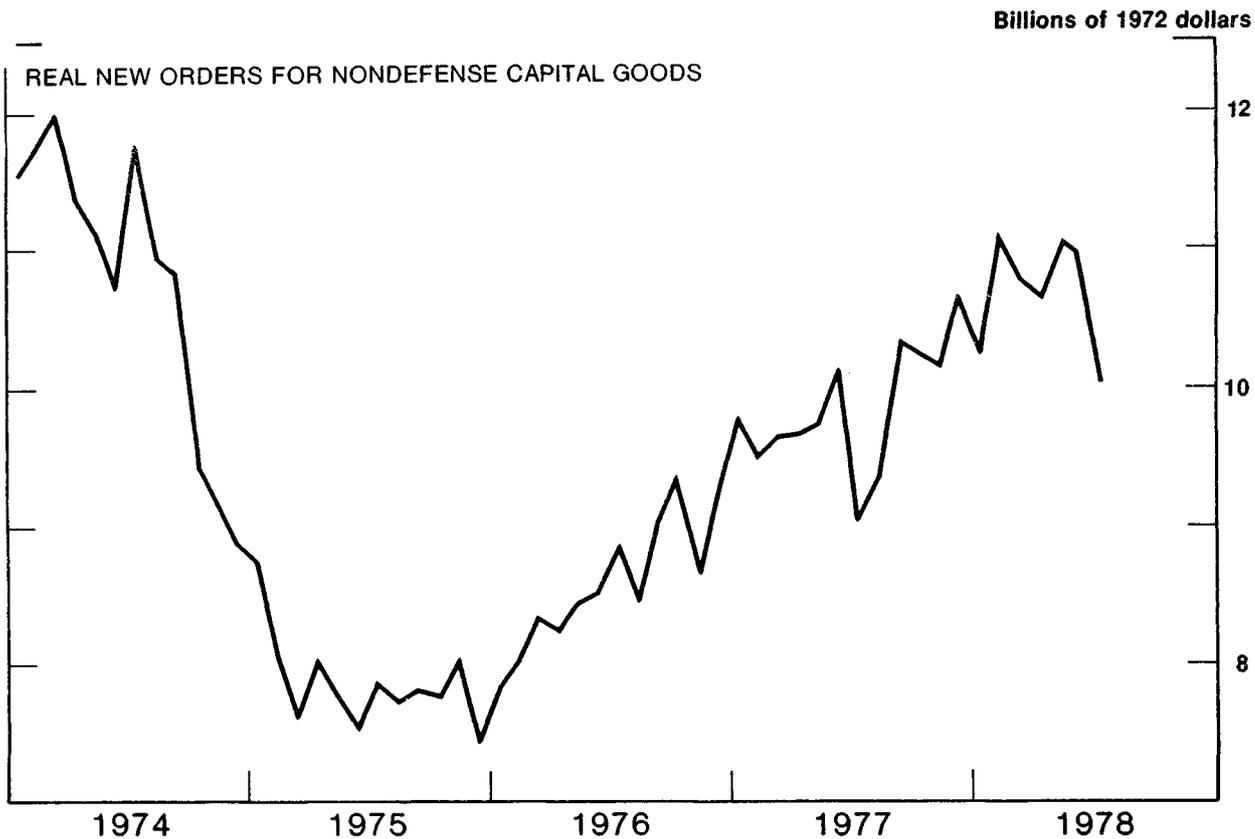
Chart 4

# PRIVATE HOUSING STARTS

Annual rate, millions of units

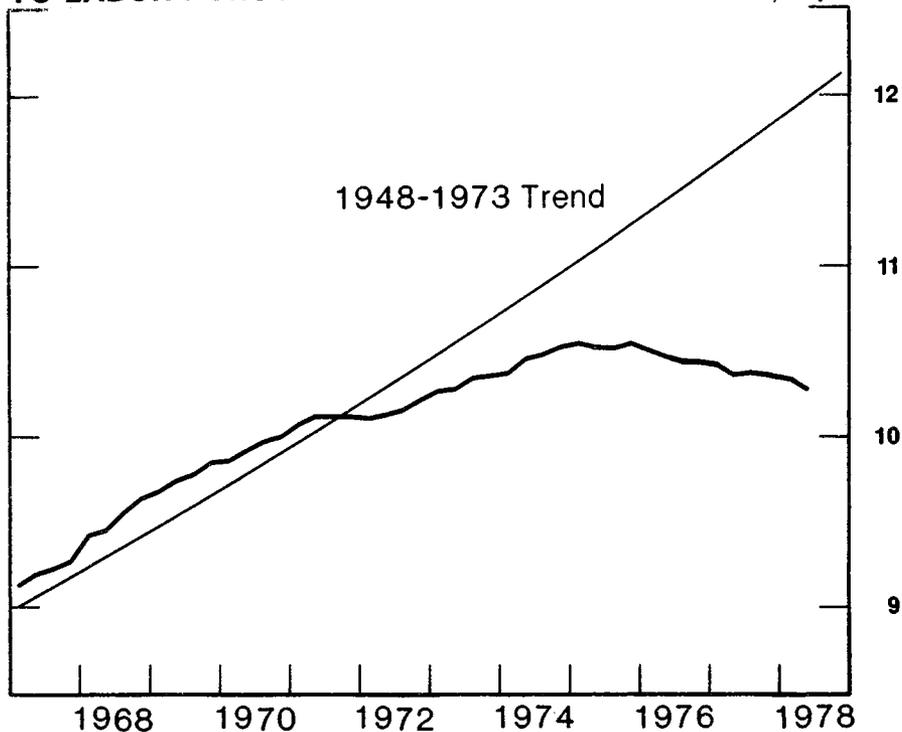


### BUSINESS CAPITAL SPENDING ACTIVITY



### RATIO OF CAPITAL STOCK TO LABOR FORCE

Thousands of constant dollars per person



### PRODUCTIVITY Output per hour, Nonfarm Business

Ratio scale, index, 1967=100

