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1972 — A Year of Rapid Economic Expansion

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THE YEAR 1972 can be considered an economic success from a number of viewpoints. Spending on goods and services rose markedly which encouraged production to increase at a faster pace than productive capacity and employment to rise about double the growth rate of population of working force age. Total wages and salaries, after adjustment for price increases, went up faster than in any year in the past two decades — even more than in 1965 when they were bolstered by a sharp rise in military outlays. Real corporate profits, which declined during the inflationary period of 1965-71, also increased rapidly in 1972.

Inflation, which has been one of the nation's most serious domestic economic problems since the mid-1960s, continued to recede during the year. Average prices rose about 3 percent, down from the peak rate of 6 percent in late 1969 and early 1970.

As 1972 draws to a close, however, economic problems remain. The economy still appears to be operating below potential, and price increases continue, although at a decelerating rate. The stimulative effects of the rise in Government spending appear excessive to some, and concern is being expressed about the effects of large Government deficits on market interest rates and the likely growth of monetary aggregates.

Before discussing in more detail the economic developments and stabilization actions taken during 1972, this article reviews the course of developments which led up to the current year. The momentum of previous events and policy actions taken before the beginning of a year have a major bearing on activity during that year. Following the review of 1972, a few comments will be made on the implications of recent trends and actions for 1973.

Framework of Analysis

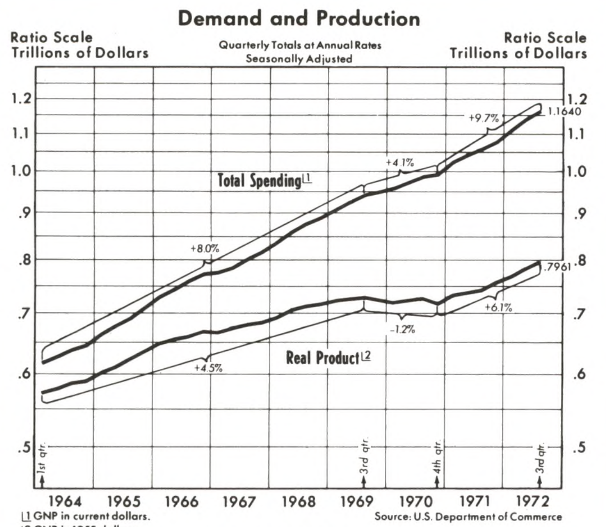
The approach used in this discussion follows a prominent view which holds that changes in the growth rate of money have important effects on spending, prices, production, and employment.[1] According to this view the trend growth of money over extended periods, say four years or longer, has a dominant effect on the trend of prices. Marked movements of money, lasting about three quarters or more, around the trend have pronounced cyclical effects on production and employment.

According to this approach, changes in fiscal actions, particularly changes in Federal spending, also have economic effects. They have some transitory effects on total spending in the economy for several quarters. These effects tend to be positive initially, and then reverse as a crowding-out effect of the financing of Government expenditures causes offsetting movements in private outlays. In addition, Government actions can alter the allocation of income, can affect long-term economic growth rates, and have been a major influence on monetary growth rates.

Background

Pronounced increases in production, employment, and incomes during 1972 were fostered by expansionary policies in 1970 and 1971. The most serious domestic economic problems of 1972, that is, inflation and unemployment, had their roots back in the mid- and late 1960s. The inflation was primarily an inheritance of the method of financing the increases in Government expenditures associated with the Vietnam conflict as well as increases in other Federal expenditures in the 1965-68 period. A new fiscal program was adopted in mid-1968, and restrictive monetary actions were initiated in early 1969. A change in the utilization of labor and other resources, along with a gradual deceleration in the rate of inflation, followed these developments in the 1970-72 period.

[1]See "Trends and Fluctuations in Monetary Growth," this *Review* (September 1972), and Leonall C. Andersen and Denis Karnosky, "The Appropriate Time Frame for Controlling Monetary Aggregates: the St. Louis Evidence" (Paper presented at the Federal Reserve Bank of Boston Conference on "Controlling Monetary Aggregates II: The Implementation," Melvin Village, New Hampshire, September 8, 1972).

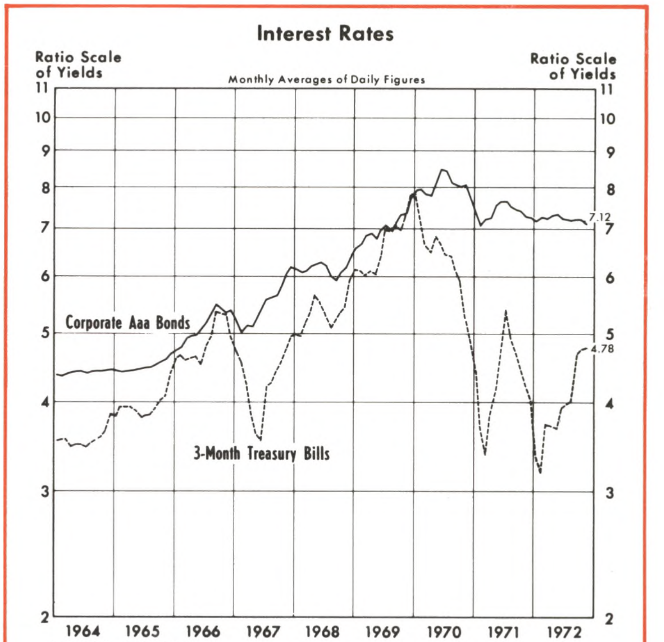


[1] GNP in current dollars.
[2] GNP in 1958 dollars.
Percentages are annual rates of change between periods indicated.
Latest data plotted: 3rd quarter
Source: U.S. Department of Commerce

During the mid- and late 1960s the expansion in total demand for goods and services became excessive. The prime stimulant to the increased spending was an acceleration in the pace of monetary expansion, which accompanied growing Federal deficits. A tax cut was adopted in 1964 with the objective of eliminating a so-called "fiscal drag." With the build-up for the war effort in Vietnam, Government purchases of military goods expanded sharply. During previous war efforts other Federal spending was usually curtailed, but in the late 1960s a great increase in Government outlays on nondefense programs paralleled the increase in military expenditures. In terms of the unified budget, the deficits grew from less than $2 billion in fiscal 1965 to over $25 billion in 1968.

Funds to finance the deficits could be attracted from savers or away from competing uses only by offering higher interest rates. The rising interest rates in the late 1960s, although performing the essential function of allocating scarce funds among competing uses, soon became a matter of great concern. Many businesses and potential homebuyers found that the cost of credit sometimes reached 10 percent or higher, and a large number of activities were curtailed. Transferring resources from private to public use meant that some private activities would be curbed. Just as increased taxes were viewed unfavorably, permitting higher interest rates to accomplish the transfer also became unpopular.

A related factor contributing to the rapid money growth was the traditional central bank policy of attempting to reduce money market uncertainties by operating on an "even keel" between the time of the announcement of Treasury offerings and the time when the securities were distributed. These actions at times of heavy Treasury borrowing resulted in the Federal Reserve supplying large amounts of credit which, in turn, fostered a rise in the nation's money stock.



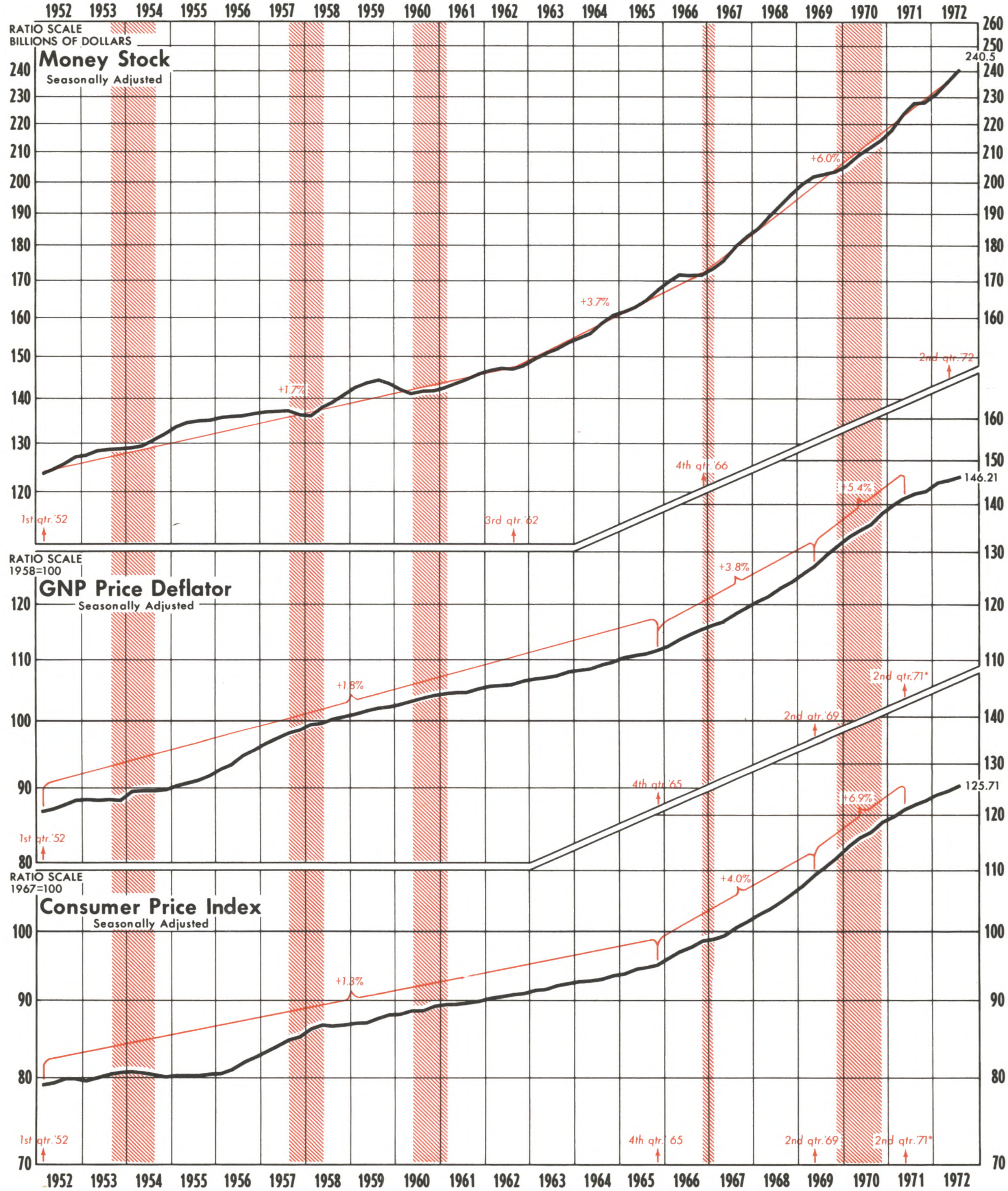
Latest data plotted: November

Also, in that period, it was believed by some that higher interest rates were an indication of monetary restraint. With a view to preventing undue rises in interest rates which some argued might cause an overall economic downturn, Reserve Bank credit was expanded at a faster rate. Such actions, in turn, contributed to the rapid rate of money growth.

Marked increases in the trend growth of money usually have been followed, after some time lag, by a faster rise in prices, and this occurred in the late 1960s. After the inflation developed it was considered to be a serious problem. The Government adopted a number of programs designed to reduce the rate of price increase. The Revenue and Expenditure Control Act, passed in mid-1968, brought some slowing in the growth of Government spending and imposed a 10 percent surcharge on income taxes. As a result, the Government's unified budget changed abruptly, from a $25 billion deficit in fiscal 1968 to a $3 billion surplus the following year. Responding to a sentiment that the fiscal actions might become too restrictive, monetary expansion was continued at a rapid rate through the end of 1968.

In view of the inflationary surge in spending which began in 1965 and continued through the summer of

Monetary Growth and Prices



The shaded areas shown in 1953-54, 1957-58, 1960-61, and 1969-70 represent periods of business recessions as defined by the National Bureau of Economic Research. The shaded area in 1966-67 represents an "unofficial mini-recession".

*Wage-price control program began in III/1971.

Latest data plotted: 3rd quarter

1969, growth in the money stock was slowed from a 7 percent annual rate in 1967 and 1968 to a 3 percent rate from early 1969 to early 1970. Subsequently, the rapid growth in total spending in the economy moderated. Then, early in 1970 the acceleration of price increases stopped, and the rate of inflation gradually began to recede. Also, production declined from the fall of 1969 to the end of 1970, and unemployment, which had averaged a low 3.5 percent of the labor force in 1969, rose to about 6 percent by late 1970.

In an attempt to minimize the adverse effects on output and employment resulting from the attack on inflation, both fiscal and monetary actions moved toward ease in 1970 and 1971. Government tax rates were reduced in several steps, and the rise in Federal spending accelerated. The unified budget position changed from a $3 billion surplus in fiscal 1969 to a $23 billion deficit in both fiscal 1971 and 1972. Growth in the money stock, which had averaged 3 percent in 1969, accelerated to a 7 percent average rate from early 1970 to late 1971.

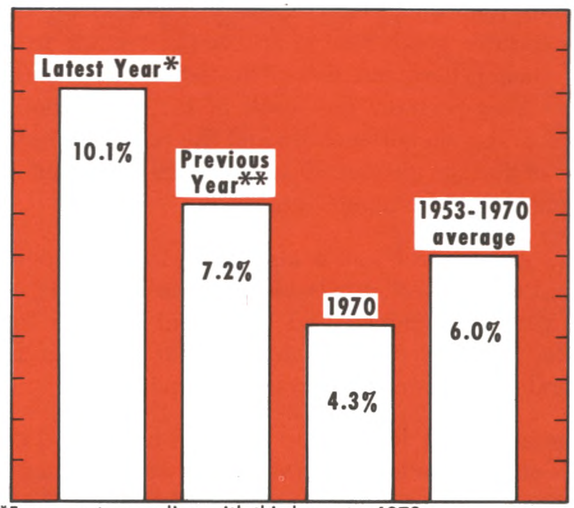
Total spending in the economy rose at a more rapid 9 percent pace during 1971 as it recovered from the effects of a major automobile strike and responded to the stimulative fiscal and monetary actions. The gradual slowing of price increases continued, and real output rose 5 percent during 1971. Despite the improvements, in the summer of 1971 inflation had declined only to about a 4.5 percent per year rate, and unemployment averaged about 6 percent of the labor force.

In an effort to quicken the progress toward reducing inflation and unemployment, the Administration turned to a new economic stabilization program in which controls played a dominant role. During the August - November 1971 period (Phase I) there was a freeze on wages and prices. Since November 1971 wages and prices have been controlled less rigidly in Phase II of the program. Stimulus to the economy was expected to result from cuts in excise taxes on automobiles, increases in personal tax exemptions, and allowance of an investment tax credit. In addition, the "floating of the dollar" and subsequent realignment of exchange rates was intended to achieve lower relative prices for U.S. produced goods in relation to foreign produced goods.

Economic Activity During 1972

As the year 1972 began, the upward momentum of spending, production, and employment was strong,

Growth in Spending



*Four quarters ending with third quarter 1972.
**Four quarters ending with third quarter 1971.

and the volume of idle resources was gradually being reduced. The trend of inflation was continuing to recede slowly. Stabilization actions of the Government leading up to 1972 had been expansive on balance, and these actions had a major influence on spending, production, and prices in 1972.

In a climate of strong upward momentum of economic activity and stimulative fiscal and monetary actions, rapid economic expansion in 1972 was virtually assured. Similarly, with the trend toward smaller price increases, the existing slack in productive facilities, and the pressure of controls, some further progress toward reducing inflation was to be expected. Most forecasts at the beginning of the year predicted such developments, and the course of activity during 1972 has generally followed the anticipated pattern.

Spending – The key to any significant expansion in output, employment, and real income has usually been a strong demand for goods and services, and such a demand was forthcoming during 1972. In response to an accelerated monetary growth, total spending on goods and services rose 10 percent from the third quarter of 1971 to the third quarter of this year. By comparison, GNP rose 7 percent in the previous four quarters, and at a trend rate of 6 percent from 1953 to 1970.

Market forces allocated the marked gains in aggregate spending across nearly every sector of the economy. Consumers increased outlays substantially. Expenditures on nondurable goods and services rose 8 percent from the third quarter of last year to the third quarter of this year, following a 6.4 percent rise in the previous four quarters. Outlays on automobiles and other durable goods rose at an even faster rate in the most recent four quarters. This latter development was at least partially the result of the elimination of the excise tax on automobiles and the relatively higher price of foreign produced automobiles following the realignment of exchange rates.

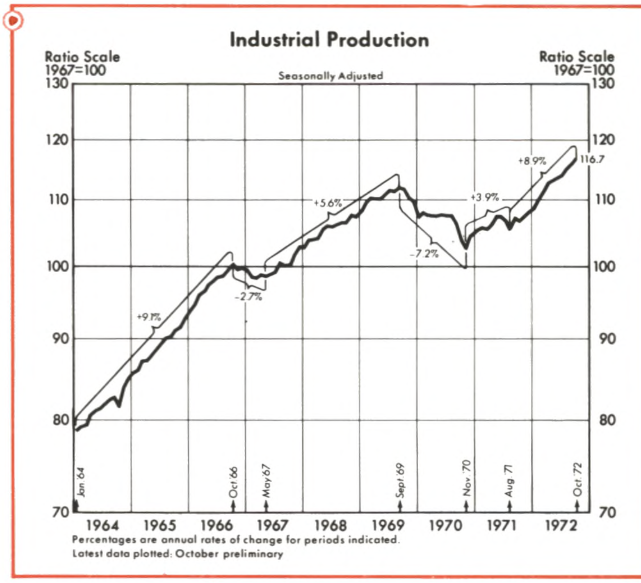
The government sector also increased its expenditures. Purchases of goods and services by state and local governments increased 11 percent from the third quarter of 1971 to the third quarter of 1972, and Federal Government outlays rose 8 percent.

The expanded demand by both consumers and governments for goods and services was accompanied by increased purchases by businesses. Gross private domestic investment rose 20 percent from the third quarter of 1971 to the third quarter of 1972, compared with 9 percent in the previous four quarters. Expenditures increased for buildings, machinery, and other equipment, and inventories expanded moderately.

Credit – Growth in spending has been facilitated, in part, by a rise in credit outstanding. Total commercial bank credit expanded at about a 14 percent annual rate in the first eleven months of 1972. Credit extended by mutual savings banks rose at a similar rate, while that extended by savings and loan associations grew at an even faster pace. Real estate loans, consumer credit, business advances, and Government indebtedness have all expanded substantially this year.

Reflecting the growing demands for funds to finance the increased spending, the cost of most credit, particularly for short-term funds, has risen this year. These rates, however, remain below average levels of recent years. Three-month Treasury bill yields, for example, averaged 5 percent in early December, up from about 3.4 percent in January this year, but down from the 6.5 percent average of 1969 and 1970. Interest rates on highest grade seasoned corporate bonds averaged 7.1 percent in early December, little changed from the level at the beginning of the year, but significantly below the average 8 percent rate for 1970.

Production – Production rose sharply in 1972, in response to the marked increase in spending. In the twelve months ending in October, industrial production, which includes manufacturing, mining, and utility firms, rose 9 percent. By comparison, industrial



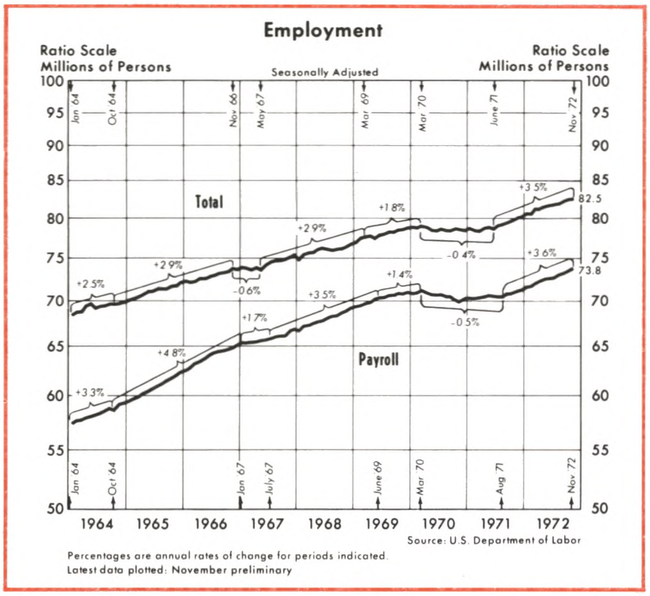
production rose 3 percent in the previous twelve months and at a 4 percent trend rate from 1952 to 1970. Most industrial sectors contributed to the greater output in 1972.

New construction put in place in the last three months (ending with October) was 11 percent greater than in the corresponding period a year earlier. Private housing starts in the first ten months of 1972 were 16 percent higher than in the corresponding period of 1971.

Real output of all goods and services rose 7.2 percent during the year ending with the third quarter of 1972. By comparison, aggregate real output increased 2.2 percent in the previous four quarters and at a 3.3 percent trend rate from 1952 to 1970.

Employment – The greater production was accomplished by a growth in the labor force, by increased utilization of labor, and by a rise in productivity. Total civilian employment rose at a 3.6 percent annual rate in the first ten months of 1972. By comparison, population of working force age (16 to 64 years) rose at less than a 2 percent rate in the same period. In 1971 employment rose 2.1 percent, and the trend growth since 1952 has been at a 1.4 percent rate.

Most categories of employment continued to rise throughout the year. Among married men, employment amounted to 97.2 percent of those seeking work in the fall of 1972, up from 96.8 percent a year earlier. For all those in the labor force, including teenagers, the elderly, and housewives, the rate was 94.5 percent, up from 94.1 percent. About half of those unemployed had been seeking work four weeks or less. In the third quarter of 1972, total employment was an estimated



64.7 percent of the population of working force age. By comparison, in the third quarter a year earlier employment amounted to 63.7 percent of this population, and in the relatively prosperous year of 1965 it averaged 63 percent.

Greater utilization of labor was also accomplished by a lengthening of the work week by some firms. Average hours worked in manufacturing rose from 39.9 in 1971 to 40.5 in the first three quarters of 1972.

Efficiency of labor utilization has increased significantly this year. In the first three quarters of 1972, output per man hour rose at a 4.7 percent annual rate. In 1971 the gain was 4.1 percent, in 1970 it was 2 percent, and in 1969 it was negative. The improved productivity has contributed greatly to the progress made in real output. Higher productivity reflects a more efficient use of resources as the economy moves toward optimal operating levels.

The greater productivity of labor was reflected in a much slower rise in production costs. In the first three quarters of 1972 private nonfarm unit labor costs rose at about a 2 percent annual rate, after rising at an average 5 percent per year pace in the previous four years.

Income – Together with greater sales, production, and employment, incomes have also been increasing markedly, and less of the gains have been lost in higher costs of living than in the previous six years. Total personal income, after adjustment for price changes, grew at a 5.6 percent rate in the first three quarters of 1972, whereas in 1971 real personal income rose 3.7 percent.

The bulk of aggregate income is in the form of payments for the services of labor. Total wage and salary disbursements rose at a 9.2 percent annual rate in the first ten months of 1972, up from 7.9 percent in 1971 and 4 percent in 1970. In real terms, wages and salaries rose 5.5 percent in 1972, compared with 4.4 percent in 1971 and a small decline in 1970. In addition, supplements to wages and salaries, bolstered by a sizable increase in employer contributions to social security, rose at a 12 percent rate in the 1972 period.

Corporate profits after taxes, which typically increase at their fastest rate in early-recovery periods, rose at a 16 percent annual rate in the first three quarters of 1972. The improved profits provide more encouragement for risk taking, a key element in economic expansion. In the 1965-70 period, by sharp contrast, profits drifted lower, and the recent recovery has only partially restored them. Profits in the third quarter of 1972 were 16 percent above their 1965 level, representing an 11 percent decline in real terms. By comparison, over the same period wage and salary disbursements rose 74 percent, a real gain of 32 percent.

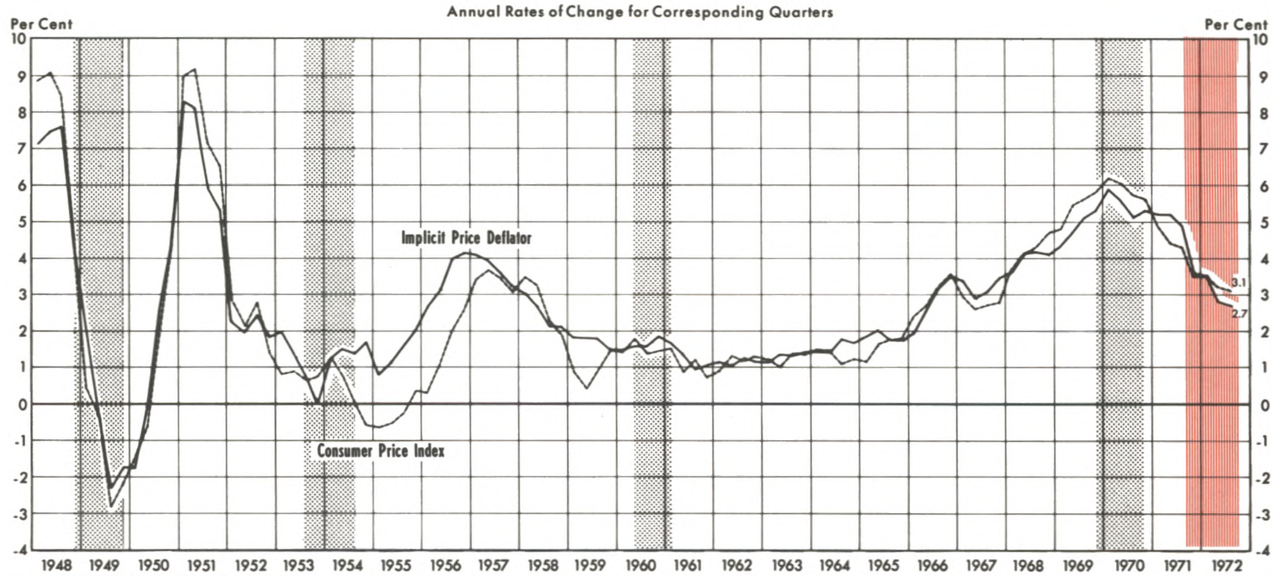
Other sources of income have also risen this year. Professional and other partnership and individual proprietor business income, farm income, and rental income each rose at a 7 percent annual rate in the first three quarters of 1972. Net interest receipts rose at a 5 percent pace.

Inflation – Since the imposition of controls in August 1971, the rate of advance in prices has continued to slow, but the pattern has been more uneven than usual. During the three-month "freeze" from mid-August to mid-November of 1971, wholesale quotations changed little, and the rise in consumer prices slowed markedly. In the first three months after the freeze was lifted, price increases accelerated, as had been expected. Since February of this year the increase in consumer prices has moderated to a 3 percent rate, compared with a 4.5 percent increase in the year ending August 1971 when the controls were imposed.

On balance, price developments since August 1971 have continued the trend toward reduced inflation that began in early 1970, and reflect to a great extent the previous monetary restraint. Wage and price controls have prevented many individual price adjustments during this period and apparently have contributed to a reduction in inflationary expectations. However, the pace at which inflation has slowed since the imposition of controls has changed little from the pace observed just prior to controls. Consumer prices rose at a 5.9 percent annual rate from the spring of

Pattern of Inflation

Annual Rates of Change for Corresponding Quarters



Implicit Price Deflator Index 1958=100: Source: U.S. Department of Commerce; Latest data plotted: 3rd quarter
Consumer Price Index 1967=100; Source: U.S. Department of Labor; Latest data plotted: 3rd quarter
The first four shaded areas represent periods of business recessions as defined by the National Bureau of Economic Research. The last shaded area represents the wage-price control period.

1969 to mid-1970. In the following fourteen months to August 1971, these prices rose at a 4.3 percent rate, a reduction of 1.6 percentage points. In the first fourteen months of controls (through October) consumer prices rose at a 3.2 percent rate, an improvement of 1.1 percentage points.

A continued moderation of the rate of increase in the consumer price index, in view of the pronounced expansion in spending, production, and incomes, may be evidence of the effect of controls on the items included in the index and covered by the programs. However, quality and product changes can influence the reliability of the standard price indexes, and there is no information on the prices of goods and services not subject to controls and not included in the indexes.

The net effect of controls is unknown since the underlying economic forces have also contributed to a lower rate of inflation. A complete evaluation of the net contribution of controls must include costs as well as benefits. With controls, freedom is sacrificed, resource allocation tends to be distorted, incentives are dulled, quality deteriorates and administrative costs must be borne.

Fiscal Developments

Fiscal and monetary actions taken before the start of 1972 have had a major influence on economic developments during the year. Actions taken during 1972 have probably played a significant role also, particularly on economic developments late in the year. Taxing and expenditure actions by the Federal Government in 1970 and 1971 probably had a temporary direct expansionary effect on the economy, and may also have been a factor influencing a faster pace of monetary expansion. Estimates for the year 1972 are that fiscal developments have had a further slight stimulative impact. Continued rises in nondefense spending more than offset an overwithholding of individual income taxes (an unexpected development which arose with a new withholding tax schedule) and sharp cutbacks in defense spending in the third quarter.

Federal expenditures have been rising at a faster pace, despite the winding down of the Vietnam conflict. Outlays rose at a 4.4 percent annual rate, on a national income accounts basis, from mid-1968 to the end of 1969. From the end of 1969 to the end of 1970, Federal spending went up 8 percent. During 1971 this spending rose 9 percent and it is estimated that in 1972 it has increased about 12 percent.

Government tax receipts have risen with the expansion in individual and corporate incomes, but the rise has been moderated by reductions in tax rates in recent years. Most significant were the removal of the ten percent tax surcharge, the Tax Reform Act of 1969, and the Revenue Act of 1971. In the latter case, personal tax exemptions were increased, excise taxes on automobiles were eliminated, and a tax credit on investment was permitted.

The combination of accelerating Government outlays and the reduced rise in tax receipts has brought about growing Government deficits. In turn, the deficits have had some temporary expansionary effects on total spending in the economy, have created pressures in financial markets, and may have led to rapid growth in the money stock. On a unified budget basis for fiscal year 1969 (ended June 30) there was a $3 billion surplus; in 1970 a $3 billion deficit; and in both 1971 and 1972 a $23 billion deficit. Projections indicate that the deficit in fiscal 1973 may exceed those of 1971 and 1972.

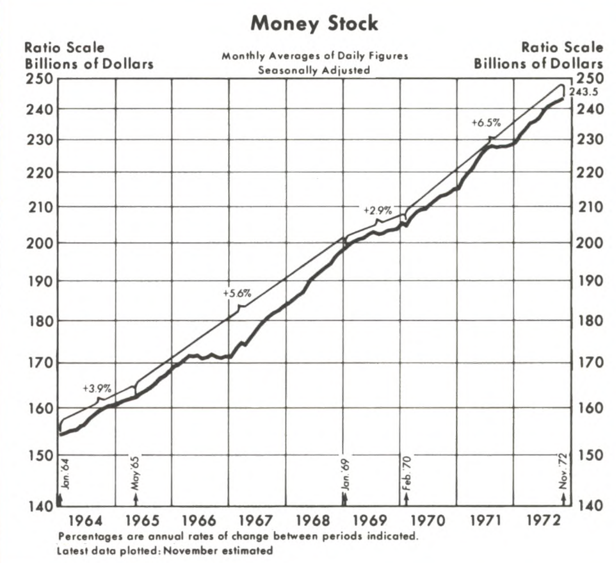
Monetary Actions

Monetary actions have also become more expansionary since 1969. In 1970 the money stock increased 5.4 percent (December 1969 to December 1970), compared with 3.2 percent in the previous twelve months. This moderate monetary stimulus was followed by a somewhat faster 6.2 percent growth in 1971 and a 7.4 percent rate of growth in the first eleven months of 1972. For comparison, the money stock grew at a 5.9 percent trend rate from late 1966 to late 1971, and at a 2.3 percent trend rate from 1952 to 1966.

Since early 1971, money stock control was given greater weight in policy deliberations. Beginning in early 1972 an attempt has been made to control the growth of money through the management of reserves available for private deposits (RPDs). During the first three months of 1972, money rose at a rapid 9.6 percent annual rate.

From March to June of 1972 money growth slowed to a 5.4 percent annual rate. Policy statements of the Federal Open Market Committee in this period called for moderate growth in the monetary aggregates. It appeared from the initial experience that managing RPDs was an adequate method of controlling monetary aggregates.

In the third quarter of 1972 the money stock rose at a rapid 8.7 percent annual rate, with most of the change occurring in July. RPDs expanded faster than money during the third quarter. The actions fostering the rapid RPD and money growth may have been in response to changed market conditions. From June to September money market conditions appeared to tighten in response to large credit demands. Interest rates were rising; the yield on three-month Treasury bills, which averaged 3.9 percent in June, moved to 4.7 percent in September. The rise in yields in this short time span would probably have been much greater had monetary expansion been less. In previous situations of apparent abrupt tightening



in money market conditions it has been traditional central bank policy to supply Reserve Bank credit with an objective of moderating rises in interest rates.[2]

In addition to System open market operations, the growth of RPDs is influenced by a number of other factors.[3] Some of the expansion of RPDs and money during the third quarter of this year was facilitated by an increase in loans from Reserve Banks to member banks. In this period, as noted above, short-term interest rates were rising markedly, but the discount rate of Reserve Banks remained unchanged at the 4.5 percent level established in December 1971. As market rates moved up relative to the discount rate, member banks had greater incentive to make short-term reserve adjustments by borrowing from Reserve Banks which adds to RPDs. The alternative would be to borrow in the market which only transfers existing RPDs.

Some financial writers, focusing on the increased member bank indebtedness to Reserve Banks, interpreted the rise in borrowing and decline of free re-

[2]At its August 15, 1972 meeting, the Federal Open Market Committee agreed that ". . . the economic situation continued to call for moderate growth in the monetary aggregates over the months ahead. It decided to seek growth in RPDs during the August - September period at an annual rate in a range of 5 to 9 percent – a rate which was expected to be associated with some moderation in monetary growth. While recognizing that pursuit of the objective for RPDs might be associated with some firming of money market conditions, the Committee agreed that a marked firming, which might precipitate unduly sharp increases in interest rates in a sensitive market atmosphere, should be avoided." ["Record of Policy Actions" of the Federal Open Market Committee, Federal Reserve *Bulletin* (November 1972), p. 977].

[3]See Charlotte E. Ruebling, "RPDs and Other Reserve Operating Targets," this *Review* (August 1972).

serves as a restrictive measure. Others continued to emphasize the rapid growth in monetary aggregates as a more reliable measure of monetary influence.

Money plus net time deposits, a broader measure that some analysts find useful, rose at a 10.3 percent annual rate in the first eleven months of 1972. From late 1966 to late 1971, this aggregate grew at an 8.2 percent trend rate. Total loans and investments of the commercial banking system increased at an advanced 14 percent pace from December last year to November. From 1966 to 1971 the trend rate of this credit was 8 percent per year.

Outlook

As 1972 ends, the upward momentum of spending, production, and incomes is strong, and the rate of inflation, as indicated by the consumer price index and GNP deflator, is the lowest since the mid-1960s. Many analysts believe that there is still room for further expansion of production before reaching full capacity. Stabilization actions taken in 1972, particularly the rapid increase in Government spending and the substantial growth in the nation's money stock, are likely to contribute to continued economic expansion in 1973. In addition, some analysts believe that large tax refunds in early 1973, as a consequence of the overwithholding in 1972, are likely to give the economy additional temporary stimulation.

The "standard" forecast for the coming year is for continued increases in spending, production, employment, and incomes at rates only slightly less than in 1972. If there is a dark cloud in the consensus outlook, it is in the area of prices. Most projections now include an emergence of greater inflationary forces by the second half of 1973. Past relationships between trend growth rates of money and prices tend to support these projections.

The Federal Budget is currently in great imbalance at a time when economic conditions suggest a more disciplined approach would be preferrable. Correction would require a tax increase or a cutback in the growth of Government spending, or both. The Administration apparently recognizes the problem and desires to trim expenditures in an effort to avoid adding to inflationary forces, still higher interest rates, and more problems for monetary stabilization.

Historical experience indicates that a movement toward a slower trend growth rate of money in 1973 would reduce the likelihood of renewed inflationary pressures. However, if spending and price developments follow their expected courses, further upward pressure on short-term interest rates is likely. In such a climate, the immediate upward pressures on interest rates associated with a slower growth rate of money would not be welcomed by borrowers. Also, past experience indicates that if the growth rate of money were to be curbed abruptly, a downturn in economic activity would be a possibility.

Conclusions

Progress against inflation, which began with the fiscal package in mid-1968 and monetary restraint initiated in early 1969, continued in 1972. By the end of the year, the rate of inflation appeared to have been close to that existing in the mid-1960s just prior to the inflationary surge. The transition to a lower rate of inflation involved costs in terms of lost production, unemployment, and some loss of freedom with the institution of controls. Yet, given the strongly imbedded inflation, the costs of reducing it appear moderate as compared with previous attempts at arresting inflation.

Output, employment, and incomes, after adjustment for price increases, rose more in 1972 than in any year in over a decade. The upward momentum of the economy plus expansionary fiscal and monetary actions during the year give strong indications that the rate of expansion will continue to be vigorous in 1973. With prevailing rates of growth in labor, capital, and technology, the recent rapid rates of growth in real output are not sustainable for an extended period. Unless the rise in total spending moderates, prices will tend to rise as the growth of output slows relative to the growth in demand for goods and services. Hence, as 1973 begins, it appears to most forecasters that inflationary pressures may mount during the year.

The Outlook for Changes in Federal Taxation

by MURRAY L. WEIDENBAUM

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This paper was presented at the Annual Conference of College and University Professors of the Federal Reserve Bank of St. Louis on November 3, 1972.

NINETEEN SEVENTY-THREE is likely to be a year of substantial change in the Federal tax system. This is not just a political forecast that I am making. It is also an economic one. There are some hard fiscal facts of life that the next Administration in Washington, be it Republican or Democrat, will inevitably be facing.

To put the situation in a nutshell, our collective appetites for new and expanded government spending programs have outrun the ability of the existing tax system to pay for them. We literally have mortgaged available Federal revenues for many years into the future. The Federal Government is running a $30 - $35 billion deficit this fiscal year. Although some improvement can be expected next year, another full-employment deficit is likely.

And still more new demands on the public purse are already clearly visible. The most notable one is in the area of public school financing, where the courts are requiring the raising of outlays for educating children in poor areas.

One pressure on the tax system is thus clear – the need to raise more revenue. But simultaneously, there is another pressure on the Federal tax structure – the drive for tax reform. Much of the public discussion is uninformed and some borders on the hysterical. Yet, there is strong voter support for Congress taking a new look at the entire complex of special benefits, complicated provisions, and alternative tax treatments of income which take up so many hundreds of pages of the Internal Revenue Code.

Senior members of the House of Representatives Ways and Means Committee have stated that tax reform will be high on the Committee's agenda in the new Congress. Let us take up three major types of changes which have been suggested in the current public debate: (1) reducing the incentives to investment, (2) changing individual deductions and exemptions, and (3) tightening up on tax-exempt or "preferred" income.

Reducing the Incentives to Investment

Quite understandably, many investors and businessmen were badly shaken by recommendations to eliminate the special tax treatment of long-term capital gains and simultaneously to repeal the investment credit and the recent liberalization of depreciation allowances. Such a combined assault on the ability and incentive to invest undoubtedly would adversely affect business sentiment and tend to reduce investment. However, too many people were overreacting.

I do not consider the enactment of this radical package at all likely. Maybe the "loophole closers" are oblivious to the side-effects of such actions, but the tax-writing committees of the Congress are not. But some reduction in these tax incentives is likely.

At present the odds favor increasing the minimum holding period in order to qualify for long-term capital gains treatment from six months to one year. Logic does force us to admit that treating a six-month investment as "long term" is an anomoly.

A related alternative being considered is a graduated tax rate depending on the length of the holding period. This would be a step towards an income-averaging approach. Another prime candidate for change is to tax capital gains at death. This would encourage older people to sell assets on which sizable gains have accrued. At present, their estates are not liable for any capital gains tax.

Also, the alternative tax on capital gains — which the taxpayer can choose instead of one-half of his regular tax rate — may be raised again. The 1969 Tax Reform Act increased the alternative rate from 25 percent to the present 30 percent. I believe that it is less likely that the Congress will repeal the recently-restored investment credit or the liberalized depreciation (ADR) system. Certainly, I believe that both actions are an improbable combination.

Changing Individual Deductions and Exemptions

No doubt we will continue to hear a great deal of talk about how "regressive" the current method of deductions and exemptions is on the Federal individual income tax. In general, I do not expect anything to come of it. Most of these so-called "loopholes" (Table I) go to average-income individuals.

The major ones in terms of revenue loss to the Treasury are the tax deductibility of state and local taxes and interest on home mortgages. These cost the Government over $11 billion a year, compared to the less than $1 billion for the depletion allowances that we hear so much about.

I just do not see much possibility of eliminating these tax breaks to individuals. The national desire to encourage home ownership continues unabated. The need to soften the impact of rising property and other state and local taxes is surely growing. Yet, we must note the special case of tax benefits to high-income housing investors; in this area, considerable sentiment is building up for reducing the tax advantages of these essentially commercial transactions.

If anything, I would expect the general tax aids to individuals to increase. The idea of a tax credit for parochial and other private school tuition is gaining favor. Property tax relief — for homeowners but not for business — has become a stock fixture in every political platform. One method of achieving that objective is a tax credit for property (or all state-local) taxes. A credit would avoid the regressive feature of the present deduction method, whereby $1 of local taxes brings a higher tax saving to the upper bracket Federal tax payer than to the lower bracket individual.

Table I

Major Federal Special Tax Provisions, 1970

Tax Provision	Revenue Loss (Millions of Dollars)
Aids to Business	
Depletion allowances	$ 980
Other aid to oil and gas industries	325
Investment credit	910
Preferred treatment of overseas earnings	350
Capital gains for timber income	130
Liberal depreciation on buildings	755
Capital gains	425
Excess bad debt reserves for banks, etc.	380
Expensing research and development	540
$25,000 surtax exemption	2,000
Rail freight car amortization	105
Subtotal	$ 6,900
Aids to Investors	
Dividend exclusion	280
Exclusion of interest on life insurance	1,050
Tax-free municipal bonds	2,300
Subtotal	$ 3,630
Aids to Farmers	
Special tax treatment	$ 820
Aids to Individuals	
Deducting interest on consumer credit	1,700
Deducting interest on home mortgages	2,800
Deducting state and local taxes	8,500
Extra exemptions for aged, blind, and disabled	2,960
Sick pay exclusion	105
Excluding unemployment benefits	400
Excluding workmen's compensation	210
Excluding pension contributions	3,250
Excluding company-paid insurance	1,915
Excluding company-provided meals and lodging	170
Deducting charitable contributions	3,750
Deducting medical expenses	1,700
Excess standard deduction over minimum	3,000
Additional exemption for students	500
Exclusion of veterans benefits	650
Exclusion of benefits to military personnel	500
Subtotal	$32,110
Total	$43,460

Another way of dealing with this problem would be to introduce a new system of Federal grants to school districts. This would permit the elimination or at least reduction of the local school property tax. But any of these alternatives of course would put a considerable burden on the U.S. Treasury. Hence, they would increase the likelihood of a general tax increase or the imposition of a new tax.

Tightening Up on Tax-Exempt or "Preferred" Income

The Tax Reform Act of 1969 established a 10 percent minimum tax on various categories of so-called "preferred income" which hitherto had escaped Federal taxation altogether. A live possibility is increasing the rate, to perhaps 20 percent. Also, the minimum tax may be extended to other categories of exempt income, notably interest on municipal and state bonds.

I do not believe that tax-exempt bonds will be eliminated, but I do attach considerable probability to the creation of a new type of taxable municipal bond, thus reducing the relative importance of the tax-exempt municipals. Such a development would require a Federal interest subsidy to the issuer to cover the difference between the higher interest rate for the taxable bonds and the lower interest rate for tax-exempts. This new supplementary way of financing state and local governments is gaining support from many who believe that the tax-exempt market will be too small to meet the capital financing needs of states and localities in the years ahead.

The income of foreign subsidiaries of American corporations also may face rougher tax treatment. One of the most frequently suggested changes is to tax such "foreign" income as it is earned, rather than the present arrangement of waiting until it is repatriated to the United States. This issue is part of a larger question of changing public attitudes toward multi-national corporations and other aspects of overseas operations of American firms.[1]

Although I do not believe the facts support the issue, many labor groups are concerned about the so-called "export" of American jobs and are pushing protectionist legislation. If anything, these overseas operations have a favorable effect on our balance of trade and our balance of payments. But economic logic does not always sway political decision-making.

Tax Increases or Expenditure Reductions

Reforming the Federal tax structure may be good for the soul – of some. It may serve the useful purpose of improving the equity of the revenue system and thus increasing voluntary taxpayer compliance. But the net amount of new revenue that it will produce is likely to be very limited. In 1969, the reforms were coupled with so much tax relief that the net effect was a substantial loss of revenue to the Treasury. I doubt that the reform measures enacted in the near future will provide the large sums that the Treasury will require.

[1]See Murray L. Weidenbaum, "Tariffs, Quotas – Or What?", *Dun's Review* (September 1972), p. 11.

Another alternative of course is to reform the expenditure side of the budget. The Administration has a major effort underway right now. The failure of the Congress to enact a $250 billion expenditure ceiling turns out not to be critical. The power of the President to reduce expenditures below the amounts appropriated (so-called "impounding" of funds) is based on both pre-existing legislation (the Antideficiency Act) and well-established custom. Personally, I would have preferred Congressionally-imposed restraint on its own appropriations. An expenditure limit permits Congress to appropriate to their hearts' content, passing the buck to the President to accomplish the unpleasant task of making the actual reductions.

A systematic review of Federal program and spending commitments might be very fruitful. Much could be done in the way of removing subsidies which have long since outlived their original justifications. Many of these programs are vestiges of the 1930s or the 1940s. They are hardly relevant to the priorities of the 1970s. Rereading the original justifications is like hearing an echo from a different age:

(1) The Davis-Bacon Act was enacted to deal with the problem of low wages in the construction industry – low wages in the building trades in the 1970s?

(2) The program of stockpiling "strategic" materials was intended to deal with the lack of an inventory of metals for extended war production – protracted trench warfare in the 1970s?

(3) The program of supplying low-interest loans by the REA was intended to deal with the lack of electricity on American farms – no lighting in the 1970s?

These programs – and many like them – should be given an honorable discharge or, better yet, a suitable burial. The problem of course is that the recipients of these special benefits constitute entrenched pressure groups which are determined to fight to keep their special privileges.

But if Congress does not cut back substantial amounts of these fiscal sacred cows, the resultant pressures will be quite clear – for a new tax, such as a value added tax (VAT) or for a substantial increase in the Federal income tax. The VAT has many pluses and minuses. It encourages efficiency in the use of resources and meshes with the tax systems of our European trading partners; it is regressive and inflationary. However, it does represent one of the last unused tax sources available to the Federal Government.

With reference to the alternative of increasing the yield of the individual income tax, there may be much justification for a basic revision of the entire rate structure. But that approach opens up such a can of worms that it likely would delay the entire legislative process. Thus, we seem to be getting used to the simpler approach of a single percentage surcharge on each individual's and corporation's basic tax liability.

Of course we should not underestimate the possibility of inaction — on the part of Congress and/or the Executive Branch. The resultant increase in inflationary pressures would put more of the stabilization burden on our friendly Federal Reserve System, as well as complicate the process of dismantling wage and price controls.

Conclusion

Whichever view prevails — the fiscal liberals who are more interested in closing all those "loopholes" or the fiscal conservatives who are concerned with the rising Federal deficits — 1973 is indeed likely to be a year of considerable action in the field of Federal taxes. Any actual changes voted, however, — particularly those raising revenues — may not become effective until 1974, when the economy may be turning soft!

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