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The New Economics: Stabilizing Tax Policy

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The New Economics : Stabilizing Tax Policy*

THE MAJOR ASPIRATIONS of the new economics for the national economy include a high rate of growth, stability in the general level of prices, and a high and steady rate of use of the labor force and other elements of production capability. The new economics is not unique in this regard, of course; these have long been the avowed objectives of public economic policy as expounded by conservative and liberal economists and politicians. This is not to say that there is nothing new in the new economics. One distinction it enjoys is its apparent disregard as a concern of public policy of efficiency in the use of production capability, or at least its ranking of efficiency considerations far down on the scale of public policy interests. Another is its willingness and eagerness to innovate with respect to the devices of public policy, without concern, apparently, for the impact of these devices on the institutions of the market place. The ill-starred wage-price guideposts and the guidelines for foreign investment illustrate this preference for pragmatism over principle in the new economics.

An additional distinction, and one more to the point of this discussion, is the confidence of new economists that through the proper use of the instrumentalities of public policy, the objectives of growth, stable prices, and a low unemployment rate can be continuously achieved, and that any failure in this regard is attributable to the institutional barriers against prompt use of the policy tools. Thus, there is a continuing drive to get the Congress to relinquish to the President the right to raise

* Author's *Note*: The views expressed herein are my own and are not to be construed as a report of findings or conclusions of the National Bureau of Economic Research.

and lower tax rates as a means of curbing recessions or booms. In this view, while it may not be possible to eliminate the business cycle completely, it can be greatly moderated by the application of the policies of the new economics.

The long term trend rate of increase in output, incidentally, can be determined, according to the new economics, through a sagacious mixture of fiscal and monetary policies. For the short run, the view appears to be that fiscal policy should be relied upon primarily to prevent booms and recessions by adjusting the so-called full employment surplus, i.e., the excess of the Federal Government's receipts over its outlays, as measured in the national income accounts, which would obtain if the economy were operating at full employment. Since it is generally assumed that most Federal expenditures cannot be altered promptly enough to even out business fluctuations, the task is usually assigned to tax policy.

Viewing Short-Run Use

The view that tax policy can be used for short-run stabilization purposes is not well founded. In the first place, the analytics of the proposition that taxes can be changed frequently and temporarily to offset economic fluctuations leave much to be desired. In the second place, even if the theoretical foundations were considerably stronger than indeed they are, there are very substantial difficulties which a tax policy for short-run stabilization would have to overcome. The postwar evidence is overwhelming to the effect that these difficulties are likely to be so severe as to preclude effective use of tax changes for short-run stabilization, and, indeed, that such a policy may very well accentuate instability. Let us consider that contention.

Suppose we disregard the question whether frequent and temporary changes in taxes,

taken by themselves, would in fact affect the demands of the private sector for goods and services. For the sake of the argument, let us assume that they would—that tax increases would curb such demands while tax reduction would stimulate them. What would be required for such tax changes to make significant contributions to tempering economic fluctuations?

To begin with, the tax changes would have to be made on a timely basis. They would have to be made in time to correct the economic disturbance at which they are aimed, and they would have to be reversed soon enough to prevent them from becoming disturbances ‘themselves, i.e., from overshooting. This raises two questions: (1) How quickly would such tax changes take effect; and (2) When do they need to take effect in order to do the job? It is clear that the more quick-acting one assumes a tax change to be, the greater would be the permissible delay in making the change to counteract the economic disturbance. Even so, it would still be necessary to learn early enough that there is a disturbance to be offset. In other words, if you can’t find out that a boom is under way until it is well along, at least some of the alleged damage will already be done by the time you wake up to the need for corrective action.

Duration Factor

One could argue that even with delayed recognition, tax action would at least keep things from getting worse. This assumes, of course, that the disturbance continues for some considerable time after it is recognized.

In short, the first set of requirements are prompt recognition of the disturbance to be offset, prompt and quickly-effective tax changes, and a lengthy duration of the disturbance.

So far as timely recognition is concerned,

the postwar record is far from heartening. It is, of course, impossible to know just when the President's economic advisers first told him, on each of the occasions since the end of the war when the economy recessed or boomed, that things were not as they should be. Relying on the public record, however, it seems clear that official recognition of economic disturbance came not only too late to prevent it from materializing, but indeed considerably after it was well under way. The only possible exceptions to this generalization are the tax increases of late 1950 and early 1951-war finance measures which were enacted relatively early after the increase in defense demands upon the economy were first felt. Even so, these tax increases were late in arriving, although it can surely be said in extenuation that there was no way of forecasting the outbreak of the Korean War and readying the necessary anti-inflationary measures beforehand. This is quite true, and illustrates one of the major difficulties in running a stabilizing tax policy: The shocks which need to be cushioned are almost invariably sharp and unanticipated, often because they originate in the unexpected action of the government.

Incidentally, the only tax change in the postwar period that may be regarded as timely was the tax reduction effective in May 1948, six months ahead of the beginning of the 1948-49 recession. This tax reduction was not meant to offset any developing recessionary tendencies—indeed, some of its proponents urged it as an anti-inflationary device. It was opposed by the Administration as contributing to inflation and was enacted over the President's veto. And by the way, for those who are confident of the effect of such fiscal changes on private sector demands, here is a problem. The May 1948 tax reduction, yielding an increase in disposable income (annual rate) of \$5 billion, was accompanied by an increase in

Federal purchases of goods and services resulting in a \$11.8 billion reduction in the Federal Government surplus in the NIPA accounts between the last quarter of 1947 and the last quarter of 1948. Why didn't that tax reduction and those expenditure increases prevent the recession in late 1948?

Subsequent to the Korean War expansion of 1950-51, recognition of every major cyclical turning point was late. The onset of the recessions of 1953-54, 1957-58, and 1960-61 was not officially identified as of the months in which they began; it is certainly fair to infer that the conditions which generated them were not recognized at the time they arose, and that the forecasts afforded the President were in error or were not persuasive.

Error Widespread

This impaired economic vision was not confined to the Executive Branch of the Federal Government. A subcommittee of the Joint Economic Committee of the Congress, reporting in June, 1957, found that the major problem in the short-run outlook was inflation and urged continuation of monetary and fiscal constraints. This cheerful view of the economy was announced about a month before the recession of 1957-58 got under way.

The subcommittee, incidentally, based its conclusions on the virtually unanimously-bullish forecasts it had received from an impressive assembly of economists in the business and academic communities. At the subcommittee hearings in early June, 1957, many leading economists asserted that tax reductions would be inappropriate in view of the inflationary strains facing the economy.

One might contend that there have been substantial advances in the art of economic forecasting and diagnosis since then, but recent experience evidences little if any progress in calling the tunes promptly.

For example, when the clamor for tax increases to curb excessive increases in aggregate demand arose in early 1966 (scarcely a month following the cries of anguish from the same quarters over the Fed's raising the discount rate in December 1965), the boom had already begun to wane. Who recognized the boom when it began in early 1965? Who called for tax increases in 1965 to constrain the expansion of aggregate demand then occurring as a result of the sharp increase in orders for defense and capital goods?

The failure to observe the onset of booms is, of course, quite understandable. The phenomenon defies useful definition, let alone recognition.

Hazard of Slow Effects

Along with prompt recognition, a successful countercyclical tax policy requires that the effects of tax changes be quickly felt. If they are slow in materializing, they may impact on the economy when the occasion for them has passed. This is a substantial hazard, considering the fact that during the postwar years cyclical movements of the sort that one might want to constrain have been of very short duration. The 1948-49 recession, for example, was 11 months in duration, the 1953-54 downturn lasted 13 months, and those of 1957-58 and 1960-61 went on for nine months. If, as has been the case, recognition of these turning points is tardy, and if, additionally, the effects of tax changes develop with any reasonable lag at all, a countercyclical tax policy almost inevitably will run well behind the developments it is designed to prevent or moderate.

The new economists often ignore this likelihood of tardy—therefore perverse—countercyclical measures. They overlook the fact of delay in recognizing the occasion for such measures, and attribute the alleged stickiness of public policy to the slowness with which

the Congress responds to the Administration's requests for action. Their answer is to transfer to the President the tax-changing authority. In fact, Congressional response has been very speedy indeed. In any case, Presidential power to change taxes would not in itself accelerate recognition of cyclical developments, nor would it reduce the lag between tax change and effect.

Some new economists deny this effect lag. The January, 1967, Economic Report, for example, explicitly attributes the slow-down in the pace of expansion after the first quarter of 1966 to tax changes enacted in mid-March 1966. This assertion of instant fisc is all the more remarkable in view of the fact that a substantial part of the revenue increase resulted from graduation of withholding and acceleration of corporate tax payments, neither of which involved any change in tax liabilities.

Not Retroactive

Even if the effects occur very quickly, however, they surely do not work retroactively. But since so much of the evidence of economic disturbance against which action is presumably to be taken is the lagged reflection of developments occurring earlier, often considerably beforehand, the tax changes will in any case be tardy unless they are put into place at the same time as the disturbances originate. For example, there is a widespread consensus among economists that the price movements measured by the Consumer Price Index are much-delayed responses to the operation of a large number of factors which go into price determination. Basing stabilization action on this month's or next month's change in the Consumer Price Index, accordingly, is shutting the barn door long after the horse has been stolen.

By the same token, tax changes to curb cap-

ital goods spending are likely to be too late unless undertaken well before the "excessive" spending is expected otherwise to occur. Spending on plant and equipment lags behind the *production* of plant and equipment by varying amounts of time, depending on the kinds of facilities involved. It is the *production* of these items, however, which generates income in the private sectors: spending, the final step in the process, represents only an exchange of existing assets between buying and selling firms, and has no net effect on the total measured output of the economy in the period when it occurs. In other words, to have had any significant impact on plant and equipment spending in 1966, which seemed to cause new economists so much alarm, tax increases aimed thereat should have been effected in 1965, and earlier in that year rather than later. By the same token, enactment of such a tax increase early in 1966 would have been appropriate only if it were forecast that plant and equipment *production* in 1966, hence *spending* in 1967, would be excessive—a forecast which, to the best of my knowledge, was scarcely if ever proffered. The suspension of the investment credit and accelerated depreciation in October, 1966, can be rationalized only if it were forecast that output of production facilities in 1967 would be excessive.

Impact Starts with Orders

In exactly the same vein, a tax increase in early 1966 to offset the increase in defense spending in 1966 would have been irrelevant. The impact of defense demands on the economy begins when orders are placed by procurement agencies for defense goods, continues while contractors acquire the production inputs they need and turn out the goods, and ends when the goods are delivered and paid for. The payment per se merely transfers funds

from the government to the contractor; it is the production of the defense goods which diverts agencies of production from other uses and which generates income.

While progress payments reduce the lag between production and expenditure they do not by any means eliminate it. It is not, therefore, the increase in defense *spending* the effects of which tax policy should, if at all, seek to offset; it is, rather, the considerably earlier increase in defense production. It is when that increase in production is getting under way that production resources may have to be reallocated from other uses, and when the demands for these resources in other uses may have to be curbed to prevent a subsequent rise in their prices and in the prices of the output they produce.

To sum up regarding this first set of requirements, a successful countercyclical tax policy would require, among other things, that tax changes be based on a forecast well in advance of economic disturbance, and that they be enacted in time to counteract the forces producing the disturbance. This in turn depends on how quick-acting, if at all, the tax changes would be. Any significant lag in effect would require tax changes well ahead of the time when awareness of the disturbance would be widespread. In this event, of course, the tax changes themselves would be signals to the business community of the Government's anticipation of recession or boom.

Zarnowitz Findings

The second set of requirements for an effective countercyclical tax policy includes (1) accurate forecasts of the excess or short fall of total money demand with reference to a full-employment, non-inflationary expansion of aggregate demand; and (2) knowledge of the magnitude of effect of any given tax change

on aggregate demand. A recently published study by Victor Zarnowitz* covering the years 1953-63 finds that the average error in forecasts of GNP for the succeeding year was 40 per cent of the average year-to-year change in GNP. The apparatus of forecasting, of course, is being continually refined and surely there is and will be improvement. But the simple fact remains that the most frequent source of disturbance in the postwar economy has been some sort of Federal Government action which could not be anticipated, often because it depended on events outside the forecaster's purview. Is there now a forecast that the world at large will begin to behave more regularly?

Determination of the relationship between a tax change of given amount and the change in aggregate demand in a given time period continues to prove elusive. There is a respectable and highly challenging thesis to the effect that there is no regular relationship of this sort, and that the theory that casts up tax multipliers is wrong. Even among those holding the contrary view, however, there is no consensus about the dimensions of the relationship.

If taxes cannot be used to prevent or moderate short-term economic disturbances, what can be done? Not much of anything, particularly to the extent that the disturbances originate unexpectedly in governmental action. To some extent, this source of fluctuation can be constrained; monetary expansion can be made more regular in line with long-term growth trends; and hastily-conceived, overly-ambitious public expenditure programs can be avoided.

But the demands to which the government

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will respond will not only continue to expand through time but to change, and when these changes and/or the government's response to them is substantial, the economy will feel the shock. If the mobility of agencies of production can be increased, and the prices of both outputs and inputs in the processes of production be made more flexible, the changes in the composition of demands and of production activity will be more readily effected, that is, the amplitude of short-term fluctuation around the long-term trend of economic expansion will be reduced. Failing these structural improvements, the best policy prescription for dealing with short-term disturbances may well be to grin and bear it.