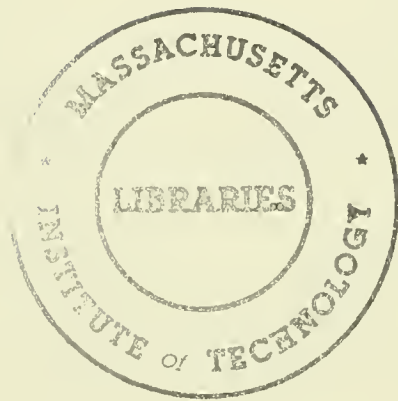


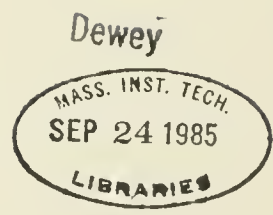
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A Tax-Based Test for Nominal Rigidities  
by  
James M. Poterba, Julio J. Rotemberg and  
Lawrence H. Summers

SSM WP#1657-85

April 1985

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A Tax-Based Test for Nominal Rigidities

ABSTRACT

In classical macroeconomic models with flexible wages and prices, whether a tax is levied on producers or consumers does not affect its incidence. However, if wages or prices are rigid in the short run, as they are in Keynesian macroeconomic models, then shifting a tax from one side of the market to the other may have real effects. Tax changes therefore provide potential tests for the presence of nominal rigidities. This paper examines the price and output effects of revenue-neutral shifts between direct and indirect taxation. The results, based on post-war data from both Great Britain and the United States, reject the view that wages and prices are completely flexible in the short run.

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The side of a market on which a tax is levied is irrelevant in the standard microeconomic analysis of taxation. Students in elementary economics learn that it makes no difference whether a sales tax is collected from buyers or sellers. They are taught that the ultimate incidence of a payroll tax depends on the elasticities of supply and demand for labor, not on whether the tax is levied on employees or employers. Broader equivalence results concerning sales and income taxes are at the heart of the analysis of general equilibrium tax incidence. Standard Keynesian macroeconomic analyses take a very different view. Raising sales taxes is thought to be inflationary, even if monetary policy remains unchanged. There is less concern that increases in direct taxation will increase the price level.

The microeconomic and Keynesian views diverge because the former presumes that all wages and prices are fully flexible, while the latter postulates rigid nominal wages. With wage rates fixed in the short run, sales tax increases necessarily raise prices; raising income taxes has no such effect. If nominal wages are rigid over reasonable lengths of time, then the conventional tax analysis must be altered. Holding monetary policy constant, increases in the price level translate point for point into reductions in output. Even a temporary one percent decline in GNP could dwarf the potential efficiency gains from many proposed tax reforms.

The very existence of nominal rigidities is a subject of contemporary macroeconomic debate. Many Keynesian scholars take it as self-evident that nominal wages are sticky, at least in the short run. For example, Solow (1980) invites his readers to "accept the apparent evidence of one's senses and take[s] it for granted that the wage does not move flexibly to clear the labor market." Other researchers claim that there is no available evidence in support of this hypothesis. For example, King and Plosser (1984) write

that "Keynesian models typically rely on implausible wage or price rigidities, from the textbook reliance on exogenous values to the recent more sophisticated effort of Fischer that relies on nominal contracts."

Examining how changes in the money stock affect macroeconomic activity, a standard test for nominal rigidities, is unlikely to resolve this issue conclusively. Shifts between direct and indirect taxation can provide tests which avoid many of the difficulties with money-based tests, since they are less likely to be endogenous responses to macroeconomic events. This paper employs both British and American data to investigate how shifts in the direct versus indirect tax mix affect wages, prices, and output. Our results support the existence of nominal rigidities and suggest that they may have important effects which should be recognized when analyzing the short-run effects of tax reform.

The paper is divided into five sections. Section I clarifies the equivalence of direct and indirect taxation when wages and prices are fully flexible. It also shows how these equivalences fail when nominal rigidities are introduced. Section II describes our methodology for examining the impact of tax changes. The next section explains how we constructed effective direct and indirect tax rates for Britain and the United States. Section IV presents our empirical findings. We examine post-war time series evidence from both countries, and also report a specific analysis of the 1979 "Thatcher experiment" in Great Britain. This tax change raised indirect taxes while lowering direct taxes commensurately, providing a strong test for the presence of nominal rigidities. The concluding section sketches the implications of our results for the analysis of tax policy and macroeconomic fluctuations.

## I. Shifts From Direct to Indirect Taxation: Classical and Keynesian Views

In textbook public finance models, the legal incidence of a sales tax is of no consequence.<sup>1</sup> It does not matter whether the tax is collected from producers or consumers. The important variables are the net price which producers receive and the gross price which consumers pay. Suppose producers of a good receive  $P$  dollars per unit sold and consumers pay  $P(1+\theta)$  dollars per unit they buy. Whether producers receive  $P(1+\theta)$  dollars and hand over  $P\theta$  dollars to the government or the  $P\theta$  dollars are collected from the consumers directly has no effect. If the government ceases to collect the tax from consumers and starts levying it on firms, firms simply raise their price by  $P\theta$ . The total amount consumers pay per unit and the net amount received by firms remains constant.

The absence of short run wage and price flexibility is the essence of Keynesian models. If the price producers charge consumers is temporarily fixed, then the legal incidence of a sales tax does matter. A switch from collecting  $P\theta$  dollars from consumers to collecting them from producers reduces the price paid by consumers to  $P$ , while the price received by firms falls to  $P(1-\theta)$ . This change affects real decisions.

This example of a sales tax in one market is only illustrative. More generally, switches between income taxes and value added or sales taxes, which essentially change the side of the market on which the tax is levied, have real consequences when there are rigidities of the standard Keynesian sort. The equivalence theorems of Break (1974) and McLure (1975) establish that in an economy without savings and with flexible prices, a sales tax on

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<sup>1</sup>. See for example Musgrave and Musgrave (1977, Chapter 20).

all goods is equivalent to an equal-revenue tax on all income.<sup>2</sup> This section begins by presenting a stylized classical macroeconomic model in which these results obtain. The second half of the section introduces wage and price stickiness and demonstrates the failure of these familiar incidence results.

### I. A. The Classical Framework

The equivalence between sales and income taxation is easily demonstrated in a simple classical macroeconomic model with perfectly flexible wages and prices. In the short run, aggregate output ( $Y$ ) is a function only of labor input ( $L$ ):

$$Y = f(L). \quad (1)$$

With competitive firms, a notional aggregate labor demand schedule can be obtained by equating the marginal product of labor to the firm's real wage:

$$f'(L) = w/s \quad (2)$$

where  $w$  is the nominal wage and  $s$  is an index of prices received by firms. The notional supply of labor depends on the purchasing power of the worker's payment for an hour of work:

$$L = g[w(1-\tau)/s(1+\theta)] \quad (3)$$

where  $\tau$  is the income tax rate and  $\theta$  is the value added tax rate. Labor supply is unaffected by any reform which does not change  $(1-\tau)/(1+\theta)$ .

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<sup>2</sup>. The equivalence of a sales tax on all goods and a value added tax has been recognized by many authors. For a particularly clear discussion see McLure (1984).



The government raises revenue from both income and sales taxes. Tax collections,  $T$ , are defined by

$$T = \tau I + \theta(E+G) \quad (4)$$

where  $I$  is pre-tax household income,  $E$  is pre-tax household expenditure on goods and services, and  $G$  is pre-tax government spending. Government spending is treated as exogenous; the national income identity requires that  $G = I - E$ . The household budget constraint in our one period model is

$$(1-\tau)I = (1+\theta)E. \quad (5)$$

To measure the government's effective tax revenue, we focus on tax receipts collected from the private sector:  $T^* = T - \theta G$ . Using (4) and (5),

$$\begin{aligned} T^* &= \left[ \tau + \frac{\theta(1-\tau)}{(1+\theta)} \right] I \\ &= \left[ 1 - (1-\tau)/(1+\theta) \right] I. \end{aligned} \quad (6)$$

Since  $I$  depends only on  $L$  which depends only on  $(1-\tau)/(1+\theta)$ ,  $T^*$  depends only on  $(1-\tau)/(1+\theta)$ . It is therefore independent of changes in the composition of taxes which leave this ratio constant.<sup>3</sup>

We now consider the effects of increasing  $\theta$  and reducing  $\tau$ , while leaving  $(1-\tau)/(1+\theta)$  constant. Clearly both the real wage paid by firms ( $w/s$ ) and the real wage received by workers  $((1-\tau)w/(1+\theta)s)$  are unaffected, so output is constant. The price level must change, however. Let  $a(Y)$  define the demand for money balances. Equilibrium requires that

$$a(Y) = \frac{M}{s(1+\theta)} \quad (7)$$

where  $M$  is the nominal money supply. We have followed the standard practice

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<sup>3</sup>. For small values of  $\theta$ , the constancy of  $(1-\tau)/(1+\theta)$  is equivalent to the constancy of  $(\tau+\theta)$ .

of assuming that the demand for real money balances, deflated by product prices, depends on real output. Since output is unaffected by the tax shift, absent a change in  $M$  the after-tax price level,  $s(1+\theta)$ , will not change. An indirect tax increase will therefore lower  $s$  in proportion to the increase in  $(1+\theta)$ . Similarly, since  $w/s$  remains constant, the nominal wage must fall.<sup>4</sup>

Alternative approaches might postulate that money demand depends on households' disposable income,  $(1-\tau)Y$ , or that money balances should be deflated by an index of consumer prices. In the former case, a revenue neutral shift towards indirect taxation would reduce prices, while in the latter case, it would raise them. In neither case would real output be affected. Mankiw and Summers (1984) present some evidence suggesting the empirical relevance of the case where money demand depends on household expenditure. Regardless of the money demand specification, tax changes will not affect the price level if nominal output is held constant.

Although shifts between direct and indirect taxes are neutral in this model, increases in either are not. Combining (2) and (3) it can be seen that reductions in  $(1-\tau)/(1+\theta)$ , which correspond to tax increases, lower equilibrium employment and output. This may raise prices. Blinder (1973) among others argues that prices may also be subject to a countervailing force, since tax increases may depress aggregate demand and lower prices. These nonneutralities, even when prices are fully flexible, make it difficult to interpret previous empirical studies of inflation and indirect

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<sup>4</sup>. A change in the direct tax rate would also affect the after-tax interest cost of holding money. However, these effects are likely to be trivial.

taxes<sup>5</sup> as shedding light on the presence of nominal rigidities. These studies establish only that nominal magnitudes tend to increase when taxes rise.

The equivalence between direct and indirect taxation on the same tax base follows from the logic of budget constraints and is not specific to the simple model considered here. In a multiple-period model, strict equivalence requires that the sales tax be levied on all goods including new investments. In an open economy, equivalence requires that sales or value added tax be collected on imported but not exported goods. This is done in practice as described by McClure (1983). Our Appendix demonstrates the equivalence of direct and indirect taxes in an extremely general context.

### I. B. The Keynesian Framework

The hallmark of Keynesian models is that nominal adjustments require time. Changes in the stock of money or shifts between direct and indirect taxation, which have no long run real effects, therefore may have important short run consequences. We illustrate this proposition by considering three different types of nominal rigidities.

Sticky nominal wages are the primary rigidity in most Keynesian models. They arise both in textbook Keynesian models and in contracting models such as that developed by Fischer (1977). Customarily, sticky wages are analyzed

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<sup>5</sup>. Some studies, such as Tait (1980), have investigated the inflationary effects of introducing value added taxes in European countries. These policy changes are hard to interpret, however, because in many cases the VAT simply replaced previous indirect taxes, such as turnover taxes. In other cases, the imposition of VAT substantially raised the total direct and indirect tax burden; this could have real effects. Other related work, such as Gordon (1971), provides some evidence that changing payroll tax rates in the United States are reflected in the price level. A survey of the broader literature on indirect taxes and inflation may be found in Nowotny (1980).

by adding a description of wage behavior to the classical model, while deleting the requirement that notional labor supply equal notional labor demand. Since both explicit and implicit contracts seem to be denominated in terms of pre-tax wages, we assume pre-tax wage rigidity. Since post-tax wages do not need to adjust to tax shifts, rigidities in  $(1-\tau)w$  do not imply that shifts between direct and indirect taxation have real effects.

Consider an increase in  $\theta$  which does not change  $(1-\tau)/(1+\theta)$ . With sticky wages,  $w$  is too high after such a shock. If firms are to remain on their notional labor demand schedules, employment must fall or prices must rise. In equilibrium, both occur to some extent since a fall in employment lowers output and therefore requires an increase in  $s(1+\theta)$  to satisfy (7). Keeping  $w$  constant, (1), (2) and (7) imply that the elasticity of the tax inclusive price with respect to a tax change is:

$$\frac{\partial \log(s(1+\theta))}{\partial \log(1+\theta)} \bigg|_{w=\bar{w}} = \frac{-a'f'\bar{w}/f''}{M/(1+\theta) - a'f'\bar{w}/f''} > 0. \quad (8)$$

An increase in indirect taxes is like a supply shock<sup>6</sup>, since prices rise and output falls. Real wages also rise, inducing firms to demand less labor and produce less output.

A second type of rigidity is real wage resistance, which Branson and Rotemberg (1980) and Sachs (1979) found in continental European countries. It can arise from indexing clauses which do not contemplate

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<sup>6</sup>. This term is usually applied to shocks such as increases in the price of an imported intermediate input (see Gordon (1975), Blinder (1981), or Rotemberg (1983b)). These shocks raise some prices, lowering real money balances and output if prices are sticky.

tax reforms. If wages are indexed to the consumer price index,  $s(1+\theta)$ , then increases in  $\theta$  will raise  $w/s$ .<sup>7</sup> This induces firms to fire workers, lower output, and raise prices after a revenue neutral shift toward indirect taxation.<sup>8</sup>

We have examined the effects of two types of wage rigidity. At the cost of some additional complexity, we could also allow for price rigidity as urged by Blanchard (1984,1985) and Rotemberg (1982). This would not alter the basic Keynesian prediction that revenue neutral shifts towards indirect taxation raise prices and reduce output. Rigidities in  $s$  would lead to increases in  $s(1+\theta)$  when  $\theta$  rises.<sup>9</sup> This lowers aggregate demand and induces firms to fire workers, possibly reducing real wages along the notional labor supply curve.

We have isolated a clear difference in the empirical implications of models with and without nominal rigidities. A natural way of testing for the existence and importance of these rigidities is to examine the response of prices and output to changes in tax structure, controlling for total revenue collections. These tests, while not totally free of ambiguity, are superior to tests of the relationship between money and output for detecting nominal rigidities. First, tax structure changes are more likely to be exogenous

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<sup>7</sup>. If indexing clauses keep  $w/s$  or  $w(1-\tau)/s(1+\theta)$  constant, then changes in  $\theta$  unaccompanied by changes in  $(1-\tau)/(1+\theta)$  will have no real effects. These variables are not affected by tax reforms even when all prices are flexible.

<sup>8</sup>. With real wage rigidities, an increase in indirect taxation could trigger a period of inflation. The nature of this inflation is extremely sensitive to assumptions about the dynamics of wage adjustment; see Poterba, Rotemberg, and Summers (1985) for further discussion.

<sup>9</sup>. Rigidities in  $s(1+\theta)$  would have no effect in isolation, since  $s(1+\theta)$  does not change when  $\theta$  changes. However, combined with rigid nominal wages, rigidities in  $s(1+\theta)$  may prevent the tax-inclusive price from rising immediately and lead instead to a period of inflation.

policy shocks than are changes in the money stock. King and Plosser (1984) argue that changes in the money stock may be endogenous. They establish that most of the observed correlation between money and output arises from changes in the money multiplier, not from changes in the stock of base money. Second, as shown in Grossman and Weiss (1985) and Rotemberg (1984), changes in the money stock which are engineered through open market operations are likely to have real effects even without nominal rigidities. Some tax changes suffer from similar difficulties, because they have incentive and distributional effects which may change real magnitudes. However, by considering increases in indirect taxes compensated by reductions in direct taxes, we minimize these problems.

## II. Methodology

We use both British and American data in studying the effects of tax changes. Britain has experienced considerably more variation in tax structure than the United States, and it therefore provides better tests for the presence of nominal rigidities. Our aim is to discover whether, and how, revenue-neutral changes in  $\tau$  and  $\theta$  affect prices, wages, and output. We test for nominal rigidities with a minimal set of maintained assumptions by studying reduced form equations which include a variety of standard aggregate variables.<sup>10</sup> We investigate whether the mix of direct and indirect taxes improves the explanatory power of these equations. Other variables are included to prevent tax switches from appearing significant only because they are correlated with relevant excluded variables.

We estimate two systems of equations. The first consists of three reduced form equations for the logarithms of prices ( $p_t$ ), nominal after-tax wages ( $w_t(1-\tau_t)$ ), and output ( $y_t$ ). The explanatory variables are lagged prices, wages, and output, as well as real government deficits ( $d_t$ ) and the logarithm of the money stock ( $m_t$ ). We also include three tax variables. The first, TTOT, is the sum of the direct and indirect tax rates. The second is TMIX, the difference between the direct and indirect tax rates. Including both TMIX and TTOT is equivalent to including indirect and direct taxes separately. However, since we are interested primarily in the effect of switches between direct and indirect taxes holding their sum constant, this specification is more natural. The third tax variable, OTAX, is the ratio of tax receipts which we classify as neither direct nor indirect taxes to GNP.

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<sup>10</sup>. Our reduced form specifications could be derived from a wide class of structural models.

This system of reduced form equations can be written as:<sup>11</sup>

$$\begin{bmatrix} p_t \\ w_t \\ y_t \end{bmatrix} = \begin{bmatrix} \alpha_p^1(L) & \alpha_w^1(L) & \alpha_y^1(L) \\ \alpha_p^2(L) & \alpha_w^2(L) & \alpha_y^2(L) \\ \alpha_p^3(L) & \alpha_w^3(L) & \alpha_y^3(L) \end{bmatrix} \begin{bmatrix} p_{t-1} \\ w_{t-1} \\ y_{t-1} \end{bmatrix} + \begin{bmatrix} \alpha_m^1(L) & \dots & \alpha_x^1(L) \\ \alpha_m^2(L) & \dots & \alpha_x^2(L) \\ \alpha_m^3(L) & \dots & \alpha_x^3(L) \end{bmatrix} \begin{bmatrix} m_t \\ d_t \\ TTOT_t \\ OTAX_t \\ TMIX_t \end{bmatrix} + \begin{bmatrix} \epsilon_{1t} \\ \epsilon_{2t} \\ \epsilon_{3t} \end{bmatrix} \quad (9)$$

where the  $\alpha^i(L)$ 's are second-order lag polynomials. We found that further lagged variables had little explanatory power. Each equation in the system also includes a time trend and seasonal dummy variables.

The equations in (9) include both the money supply and the deficit as controls for the state of government economic stimulus. These are essentially predetermined policy variables. In principle, it would also be desirable to control for shocks to the money demand equation which influence prices and output. If policy is set so as to offset these shocks, it may be appropriate to use nominal GNP as a summary variable for the effects of aggregate demand policies. These considerations led Gordon (1982) to pioneer the use of nominal GNP in wage and price equations. While this approach captures velocity shocks, it may capture too much: the disadvantage of including nominal GNP in these equations is that it may not be a predetermined variable.

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<sup>11</sup> This system of equations can be thought of as emerging from a structural model like that of Blanchard (1985), which includes an aggregate demand equation, a pricing equation and a wage setting equation.



We estimated a second system of only two equations, for nominal after-tax wages and prices, which included current and lagged nominal GNP in place of the deficit and the money supply. This system of equations is given by

$$\begin{bmatrix} p_t \\ w_t \end{bmatrix} = \begin{bmatrix} \beta_p^1(L) & \beta_w^1(L) \\ \beta_p^2(L) & \beta_w^2(L) \end{bmatrix} \begin{bmatrix} p_{t-1} \\ w_{t-1} \end{bmatrix} + \begin{bmatrix} \beta_n^1(L) & \dots & \beta_x^1(L) \\ \beta_n^2(L) & \dots & \beta_x^2(L) \end{bmatrix} \begin{bmatrix} n_t \\ \text{TTOT}_t \\ \text{OTAX}_t \\ \text{TMIX}_t \end{bmatrix} + \begin{bmatrix} v_{1t} \\ v_{2t} \end{bmatrix} \quad (10)$$

where  $n_t$  is the logarithm of nominal GNP. In this system, movements in output for a given nominal GNP can be calculated from price movements.

Systems (9) and (10) allow for unrestricted wage, price, and output responses to shifts between direct and indirect taxation. Both Keynesian and classical models imply, however, that revenue neutral tax switches are neutral in the long run. We therefore impose long-run neutrality, while testing for short-run TMIX effects, by restricting the sum of the TMIX coefficients in each equation to equal zero. The short-run tax neutrality hypothesis implies the restrictions

$$H_0: \alpha_x^1(L) = \alpha_x^2(L) = \alpha_x^3(L) = 0$$

in system (9) and

$$H_0: \beta_x^1(L) = \beta_x^2(L) = 0$$

in system (10). As long as TMIX is a valid exogenous variable, rejection of  $H_0$  is very unfavorable to the classical model. In Section IV we consider some, in our view unlikely, reasons why TMIX might appear to matter even if wages and prices were perfectly flexible.

After rejecting these null hypotheses, we focus on the relevance of these rejections for the presence of nominal rigidities. If nominal rigidities are present, then we expect prices to rise and output to fall for some time after a tax switch. The response of real wages depends on whether price or wage rigidities are more important. To investigate these dynamic effects, we compute our systems' predicted responses to a permanent change in TMIX. We also followed Mishkin's (1979) approach and examined the effect of a TMIX impulse given its actual stochastic process. This procedure avoids the problems which might arise if permanent shocks to TMIX are widely at variance with the historical experience. Because the results were very similar to those for permanent shocks, only the latter are reported in Section IV.

The reduced forms described above may be subject to some of the criticisms which have been directed at the vector autoregression approach of Sims (1980). We have not posited an explicit structural model, and the parameters in our reduced forms might vary with changes in the policy regime. However, we use our reduced forms only to estimate the effects of certain policy changes within a given policy regime. Our view is not that our equations explain how TMIX could be used as a major tool of stabilization policy, or even the effects of radical changes in the TMIX variable outside the sample experience. Rather, we believe that the estimated response of prices and output to changes in TMIX, given the current policy regime, can shed light on the existence of nominal rigidities.

Any argument of this type must confront issues similar to those raised in the decades-long debate about the relationship between money and output. The essential identification problem there involves the possibility that money and output are correlated either because they both respond to some

third factor, or because changes in money are caused by expectations of changes in output. After presenting our empirical results, we present some evidence supporting the exogeneity of tax changes. At a minimum, it seems clear that changes in the tax mix correspond to the ideal experiment for studying nominal rigidities much more closely than do money supply changes.

### III. The Data

This section describes our method for constructing measures of the direct and indirect tax burden in Great Britain and the United States. It begins by discussing conceptual measurement issues which apply to both countries. It then considers the data for each nation in some detail.

Direct taxes are defined as taxes on individuals, including income taxes and employee contributions for social insurance. Indirect taxes are those collected from firms. They include sales and value added taxes, employer contributions for social insurance, and various excise taxes. Our measured tax rates,  $\tilde{\tau}$  and  $\tilde{\theta}$ , are defined as direct and indirect tax receipts as a share of GNP at market prices. These variables do not correspond precisely to the actual tax rates,  $\tau$  and  $\theta$ , of Section I. Following the notation there, let  $(1+\theta)E$  denote tax-inclusive consumer expenditure and  $I$  household income. Government expenditure equals  $G(1+\theta)$ , and gross national product measured at market prices is  $(1+\theta)(E+G)$ . The national income identity ensures that  $I = G+E$ . Our measured tax rates are therefore

$$\tilde{\tau} = \frac{\tau I}{(1+\theta)(G+E)} = \frac{\tau}{1+\theta} \quad (11)$$

and

$$\tilde{\theta} = \frac{\theta(G+E)}{(1+\theta)(G+E)} = \frac{\theta}{1+\theta} . \quad (12)$$

Both measured tax rates are slightly lower than their actual rates in our stylized economy. This will induce a bias in our measurement of TMIX, since

$$TMIX = \tilde{\tau} - \tilde{\theta} = \frac{\tau - \theta}{1 + \theta} . \quad (13)$$

For values of  $\theta$  between 0 and .15, however, as in our sample, this bias is

small. In contrast, the measured tax rates yield exactly the correct measure for the total tax burden, TTOT:

$$TTOT = \tilde{\tau} + \tilde{\theta} = \frac{\tau + \theta}{1 + \theta} . \quad (14)$$

In Section I we discussed tax reforms which altered  $\tau$  or  $\theta$  while keeping  $(1-\tau)/(1+\theta)$  constant. Since

$$1 - \frac{(1-\tau)}{1+\theta} = \frac{\tau+\theta}{1+\theta} \quad (15)$$

a tax reform with no effect on  $(1-\tau)/(1+\theta)$  will not change TTOT.

This approach to measuring tax rates is only one of many possibilities. Ideally, we would like our tax variables to be legislated tax rates which change only when government policy changes. Unfortunately, taxes are too complex for us to define either the direct tax rate or the indirect tax rate. The tax base is much less than GNP and taxes are frequently raised or lowered by changing the tax base. If the elasticities of direct and indirect tax receipts with respect to GNP are different, then the the measured TTOT and TMIX variables will be affected by cyclical fluctuations. This could lead to a spurious correlation between the tax variables, prices, and output.

We therefore employ two other techniques for identifying shifts between direct and indirect taxation. First, using data on full employment receipts and GNP, we define full employment TMIX and TTOT. This purges these variables of cyclical fluctuations. We adopted still another procedure for identifying tax changes in the British data, by studying the response of prices, wages, and output to dummy variables which correspond to large tax reforms. Although this technique does not use all the information we have

about the nature of these tax reforms, it avoids the problems of spurious correlation which may contaminate our other results.

### III. A. The United Kingdom

Direct taxes in the United Kingdom consist of personal income taxes and surtaxes, and employee's national insurance contributions. Indirect taxes include a variety of different levies: Purchase Tax (prior to 1972), Value Added Tax, stamp, customs, alcohol, and tobacco duties, car tax, as well as employers contributions for National Insurance and Selective Employment Tax. Data on tax receipts were obtained from Financial Statistics and unpublished tabulations provided by the Central Statistical Office. A detailed data description is available from the authors on request.

The resulting shares of direct and indirect taxes in GDP are shown in Table 1. The share of indirect taxes ranges from just over eleven percent in 1963, to more than fifteen percent during the early 1980s. There are even more significant movements in the direct tax share, which varies between 10.1 and 16.8 percent. The table also shows that there are some tax reforms which correspond to shifts between the two sources of revenue. In particular, the 1979 tax reform involved a reduction of basic statutory income tax rates accompanied by systematic increases in VAT. The direct tax cuts were forecast to reduce revenue by 4.5 billion pounds, while the increase in VAT was expected to raise of 4.2 billion. This is the cleanest example of a tax reform which changed the "side of the market" on which taxes are levied.<sup>12</sup>

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<sup>12</sup>. Our econometric techniques allow us to investigate tax reforms which are not revenue neutral, since we include both the total tax burden as well as the tax mix in our equations.

Table 1: Direct and Indirect Taxes in the United Kingdom and the United States

	United Kingdom		United States	
	<u>Direct Taxes</u>	<u>Indirect Taxes</u>	<u>Direct Taxes</u>	<u>Indirect Taxes</u>
	GDP	GDP	GNP	GNP
1947	-		9.2	6.2
1948	-		8.0	5.6
1949	-		7.1	5.9
1950	-		7.3	5.9
1951	-		9.0	5.7
1952	-		10.0	5.8
1953	-		9.9	5.8
1954	-		9.2	5.6
1955	-		9.2	5.7
1956	-		9.8	5.9
1957	-		10.0	6.1
1958	-		9.8	6.2
1959	-		10.0	6.5
1960	-		10.6	6.9
1961	-		10.5	7.0
1962	-		10.6	7.1
1963	10.1	11.2	10.8	7.2
1964	10.1	11.4	9.8	7.1
1965	11.0	12.0	10.0	6.9
1966	11.7	12.3	10.8	6.9
1967	12.1	12.9	11.4	7.0
1968	12.5	13.7	12.3	7.3
1969	13.2	15.3	13.5	7.5
1970	13.9	13.7	12.9	7.6
1971	13.5	12.5	12.0	7.7
1972	12.8	12.4	13.0	7.8
1973	13.0	11.9	12.9	8.1
1974	15.1	12.4	13.6	8.2
1975	16.8	12.4	12.5	8.1
1976	16.5	12.4	13.0	8.1
1977	15.1	12.9	13.3	8.0
1978	14.0	12.7	13.6	8.1
1979	13.2	14.2	14.2	8.0
1980	13.5	14.7	14.5	8.2
1981	14.0	15.1	15.0	8.6
1982	14.2	14.8	15.0	8.4
1983	14.0	14.5	14.1	8.6
1984	-	-	13.8	8.7

Notes: Columns 1 and 2 report the shares of direct and indirect taxes in the gross domestic product of the United Kingdom, measured at market prices. Columns 3 and 4 report U.S. direct and indirect taxes as a share of GNP. Data series were constructed by the authors; see text for further details.

We measure the British price level using the deflator for GDP at market prices, and also report results using the Retail Price Index. Our nominal wage measure is the index of basic weekly wage rates in all industries and services. Output is measured by real GDP at market prices. Our equations also include the logarithm of M1, the deficit as measured by the Public Sector Borrowing Requirement, and the level of other tax receipts, defined as total government tax receipts less direct and indirect taxes.<sup>13</sup>

There are several intervals of statutory wage and price controls and implicit wage-price guidelines during our sample period. Previous attempts to find significant effects from price controls, for example Sargan (1980), have been unsuccessful. Wage controls do appear to have had some impact on wage growth, however. Henry (1981) identifies five periods of statutory wage restraint and associated wage catch-up. We include his set of indicator variables for wage controls in all of our British reduced form equations.<sup>14</sup>

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<sup>13</sup>. Quarterly PSBR and M1 data are only available since 1963, and the wage series which we use was not computed after 1983. Our sample period is therefore limited to the eighty-four quarters between 1963:1 and 1983:4 inclusive.

<sup>14</sup>. There is some disagreement regarding the most binding periods of wage control. Gordon (1983) uses dummy variables which differ from those in Henry (1981), and Wadhvani (1983) uses yet another set. Our results were insensitive to alternative choices. We amend Henry's (1981) variables by adding an indicator variable for rapid wage growth in the second quarter of 1978.



### III. B. The United States

Direct tax receipts for the United States include federal personal income tax receipts, state and local personal income tax receipts, and personal contributions for social insurance. Our measure of indirect taxes is the sum of federal indirect business taxes, which consist of both excise taxes and customs duties, state and local sales tax receipts, and private employer contributions for social insurance.<sup>15</sup> Direct and indirect tax receipts as a fraction of GNP are shown in the last two columns of Table 1. The share of direct taxes in GNP displays substantial variability in the post-war period, ranging from only seven percent in 1949 to nearly fifteen percent early in the 1980s. Indirect taxes are much less volatile, ranging between 5.7 and 8.7 percent of GNP and trending upward throughout the sample period.

We measure the U.S. price level using both the GNP deflator and the Urban Worker Consumer Price Index for all goods except shelter.<sup>16</sup> Wages are measured as average hourly earnings in manufacturing, and output as GNP in 1972 dollars. Our equations include the logarithm of M1, the level of the total government deficit, and other tax receipts which are defined as total tax receipts less direct and indirect taxes. We also include two variables drawn from Gordon and King (1982) to allow for the impact of wage and price controls during the early 1970s.

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<sup>15</sup>. We excluded state and local government employer contributions from our calculation of social insurance contributions by employers.

<sup>16</sup>. The CPI's treatment of mortgage interest is widely regarded as a source of spurious movement. We therefore exclude the shelter component.

#### IV. Empirical Findings

This section reports three sets of estimates of how switches between direct and indirect taxation affect nominal wages, prices, and output. The first sub-section focuses on the impact of the 1979 Thatcher experiment in Great Britain, because it is the clearest example of a switch between direct and indirect taxation. We then consider the British experience more generally, using the TMIX variable discussed in the last section. The third sub-section reports results using post-war American data. The section closes with a discussion of several qualifications to our findings.

##### IV. A. A Major Episode of Tax Reform: The Thatcher Experiment

The Conservative Budget on June 12, 1979 called for: (i) reducing the basic rate of income tax, the rate paid by virtually all British workers, from 33 to 30 percent; (ii) raising income tax personal allowances, the analogue of deductions in the United States; (iii) reducing top income tax rates from 83 to 60 percent; and (iv) raising Value Added Tax rates, which were previously either 8.5 or 12.5 percent, to 15 percent. This is therefore very similar to our ideal "tax switch" experiment.<sup>17</sup>

This tax reform is widely thought to have generated substantial inflationary pressure in the second half of 1979. Buiters and Miller (1981) suggest that:

"... the rate of inflation increased sharply in the third quarter of 1979 as a direct consequence of the seven percent increase in the VAT in the June budget, ... which was estimated to have added about four points to the average level of prices... Given the convention of effectively indexing annual pay claims for past inflation, there can be little doubt that the increase

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<sup>17</sup>. The Value Added Tax applies to roughly half of consumer expenditure in Great Britain.

of the value added tax in June 1979 helped to keep the pace of settlements at a high level in the subsequent pay round."

Previous attempts to estimate the inflationary effects of the 1979 reform have multiplied the change in indirect tax rates for different categories of goods by the share of consumer expenditure in each category. This approach assumes that pre-VAT prices are not affected by the policy change. Moreover, it ignores the data on what actually occurred in the second and third quarters of 1979.

Our technique for analyzing this tax shift is to include indicator variables for the quarters around the change in tax regime in our wage, price, and output equations, and then to use these estimated coefficients to assess the reform's impact.<sup>18</sup> We include indicator variables for both the quarter of the change and several quarters thereafter. This avoids imposing dynamics which we estimate from the rest of the sample on the 1979 experience.

Estimates of equation systems (9) and (10), including the dummy variables for the 1979 tax shock, are reported in Appendix Table A-1. They employ British data for the 1963-1983 period. Both sets of estimates suggest the importance of the 1979 changes in affecting prices, wages, and output. To test the short-run tax neutrality hypothesis, we test the null hypothesis that DUM793 does not belong in our equation systems. The test statistic for excluding DUM793 is 41.1 for system (9), and 13.7 for system (10).<sup>19</sup> These

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18. The budget change occurred on June 12, 1979. We define a variable equal to 0 before 1979:2, 1/6 for 1979:2, and 1 thereafter to indicate the presence of the post-1979 regime. The quarterly difference in this variable, called DUM793, is our regression variable.

19. We compute Wald tests of the exclusion restrictions as in Theil (1971, Section 8.6).

test statistics are distributed as  $\chi^2(9)$  and  $\chi^2(6)$ , respectively, under the null hypothesis. In both cases, we reject the exclusion restrictions at the .05 confidence level; in system (9), the rejection is also clear at the .01 level.

To investigate the dynamic effects of the 1979 tax change, we compute impulse response functions for prices, wages, and output with respect to an increase in DUM793. Because the response functions for systems (9) and (10) were similar, we report only those for system (9). Figure I shows both the point estimates for these impulse response functions, and also reports the one standard error band around these estimates.<sup>20</sup>

The response functions show the significant movements of wages, prices, and output after a shock like the 1979 tax reform. The price level rises at the time of the tax reform by about four percent and it continues rising for eight additional quarters.<sup>21</sup> At the peak, prices are 8.7 percent higher than they were before the tax reform; recall that with fixed pretax prices, the price level would have risen roughly four percent. Beginning ten quarters after the shock, prices decline. The null hypothesis that the price effect is zero can be rejected at the .05 level in each of the first ten quarters after the change.<sup>22</sup>

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<sup>20</sup>. The standard errors for the impulse response functions are computed using standard asymptotic methods. Defining  $f(\hat{\alpha}, t)$  as the impulse response function  $t$  periods after the shock, and  $\hat{\alpha}$  the coefficient estimates from (9), we compute the variance of  $f(\hat{\alpha}, t)$  as  $\nabla f' \Omega \nabla f$ , where  $\nabla f$  is the vector of derivatives of  $f$  with respect to  $\hat{\alpha}$ , and  $\Omega$  is the covariance matrix of  $\hat{\alpha}$ .

<sup>21</sup>. This pattern of price dynamics suggests the presence of price stickiness, as well as possible wage rigidity.

<sup>22</sup>. The sum of the price deviations for ten quarters after the shock is 77.6 percent. The hypothesis that this sum equals zero can be rejected at the .01 confidence level.

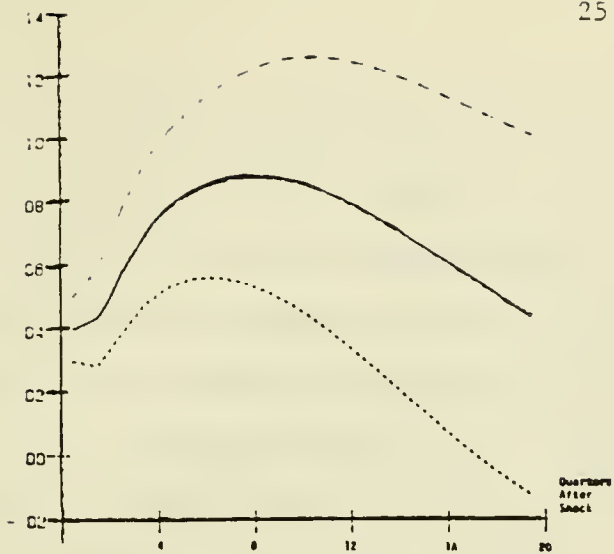


Figure I-a:  
Deviation of Prices from  
Pre-Tax Level (Percentage Points)

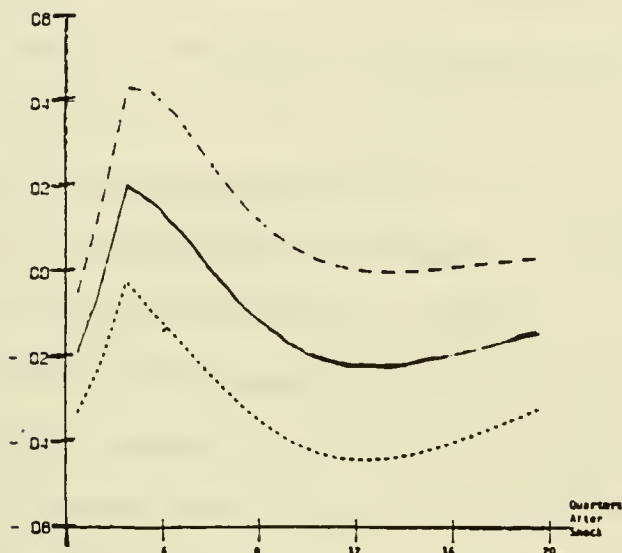


Figure I-b:  
Deviation of Real Wages from  
Pre-Tax Level (Percentage Points)

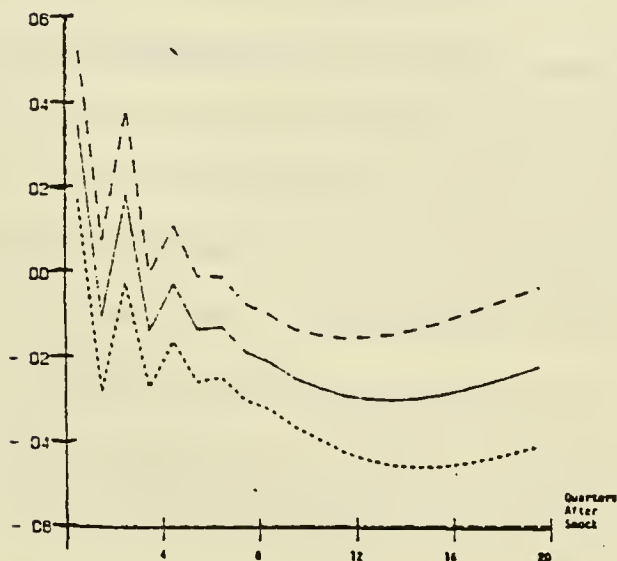


Figure I-c:  
Deviation of Output from  
Pre-Tax Level (Percentage Points)

Figure I: Estimated Impulse Responses to the 1979 British Tax Reform  
Estimates for Great Britain based on modified System (9)

Figure I also shows that real wages fall at the time of the tax shock. Thereafter, they rise for two quarters and reach a point two percent above their initial level. They then converge to the new steady state in an oscillatory fashion. This appears inconsistent with wage stickiness alone. On the contrary it suggests that firms, unwilling to lower the prices they receive, move down the supply curve for labor. Output also follows an oscillatory pattern after the tax change. Although the rise in output immediately following the shock is puzzling, output eventually declines by a substantial amount. After twelve quarters, output is nearly three percent below its starting value. These output deviations are statistically significant at standard levels.<sup>23</sup>

Two problems could affect our results. First, 1979 was a period of dramatic price change world wide as a result of substantial oil price increases. Some part of the price effect which we attribute to the tax reform may, therefore, be spurious. Although the most substantial oil price shocks occurred in the last quarter of 1979, well after the tax change, some contamination could occur nonetheless. To control for the effect of oil price changes, we added the logarithm of the Wholesale Price Index for Crude Oil to our equations. This variable had a t-statistic exceeding four, but its inclusion did not alter our conclusions about the 1979 tax reform.

The second problem is that evidence based on only one event, such as this, is especially prone to contamination by omitted variables. Fortunately, there is another recent British tax event which, while not as stark as the 1979 tax switch, also provides a potential test for nominal rigidities. In April, 1976, after a year of popular dissatisfaction with 25

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<sup>23</sup>. Note that the incentive effects of the 1979 reform, if anything, should have raised output. The finding of lower real GDP is therefore hard to attribute to the microeconomic effects of the tax reform.

percent VAT rates on durables, the government reduced them to 12.5 percent. This should have lowered the tax-inclusive price level. When we add indicator variables for these changes to our equations, we can easily reject the null hypothesis that they have zero coefficients. The results suggest a substantial downward effect on prices after the tax change. All of the results on the 1979 and 1976 tax changes are robust with respect to changes in the price level variable; equations estimated with the Retail Price Index actually suggest larger tax effects. The results are also insensitive to inclusion of exchange rate variables.<sup>24</sup>

Our dummy-variable procedures are not as efficient as the TMIX method at exploiting the time-series variation in British tax rates, and they do not constrain equal-sized tax reforms to have the same effect each time they occur. However, they do enable us to focus on the most dramatic and potentially most informative changes in tax policy. They also reduce the danger of spurious findings due to cyclical fluctuations in the tax variables. To employ data for a longer period to investigate the impact of tax shifts, we now turn to the TMIX approach which was described in the last section.

#### IV. B. United Kingdom TMIX Results

Parameter estimates for equation systems (9) and (10) including the TMIX variable are shown in Appendix Table A-2. Like the DUM793 equations above, they are based on data from the 1963-1983 period. Both systems suggest that changes in the direct versus indirect tax mix have substantial effects. The

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<sup>24</sup>. Our discussion has focussed on the results from system (9). The findings from system (10), which are reported in the bottom panels of Table A-1, are similar.

null hypothesis that the TMIX coefficients equal zero is rejected decisively in each case. The test statistic in system (9) is 32.5; it is distributed  $\chi^2(6)$  under the null hypothesis that the tax mix variables have no effect on the short run movements in wages, prices, and output. The null hypothesis is rejected at the .01 level. For system (10), the test statistic is 27.62. In this case, with only two equations, the test statistic is distributed  $\chi^2(4)$  under the null hypothesis; again, we reject the neutrality hypothesis at the .01 level. These overwhelming rejections suggest the potential importance of nominal rigidities.

To describe the effect of increasing indirect taxes, we compute impulse response functions for prices, wages, and output with respect to a one percent increase in TMIX. This corresponds to an indirect tax increase of one half of one percent of GDP, accompanied by an equal-revenue reduction in direct taxes. If all pre-tax prices remained fixed, the tax inclusive price level would rise by one half of one percent. The impulse response functions for system (9) are shown in Figure II.

In the quarter when the tax change occurs, prices are estimated to rise by three tenths of one percent. They continue to rise for eight quarters thereafter, peaking .54 percent above their initial level eight quarters after the shock. Prices then decline, but remain more than .1 percent above their initial value for four and one half years after the tax change. For the first five quarters after the shock, the sum of the deviations of the price level from its initial value is 2.04, with a standard error of 0.965. The null hypothesis of no price effects over this horizon is rejected at the .05 level. Similarly, over a ten quarter horizon, the sum of the price effects is 4.56, with a standard error of 2.24. The t-statistic associated



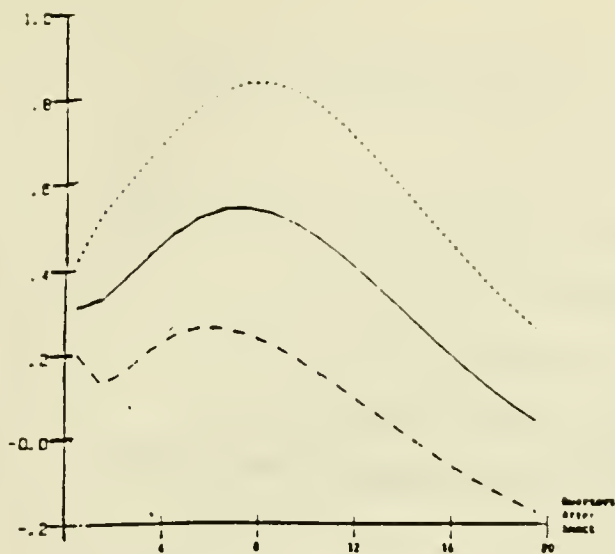


Figure II-a:  
Deviation in Prices from  
Pre-Tax Level (Percent)

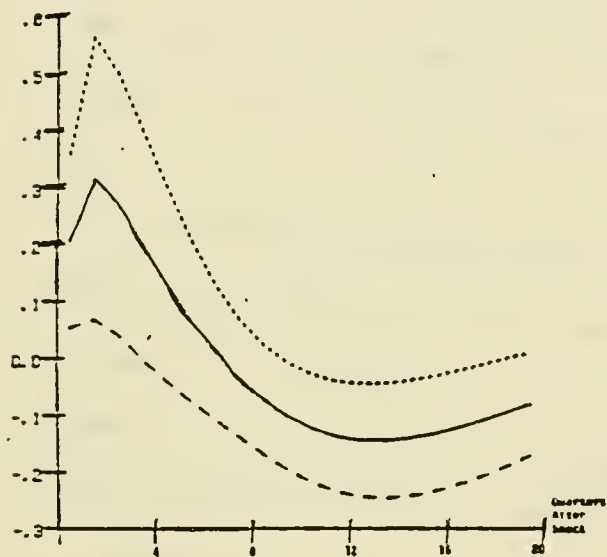


Figure II-b:  
Deviation in Real Wages from  
Pre-Tax Level (Percent)

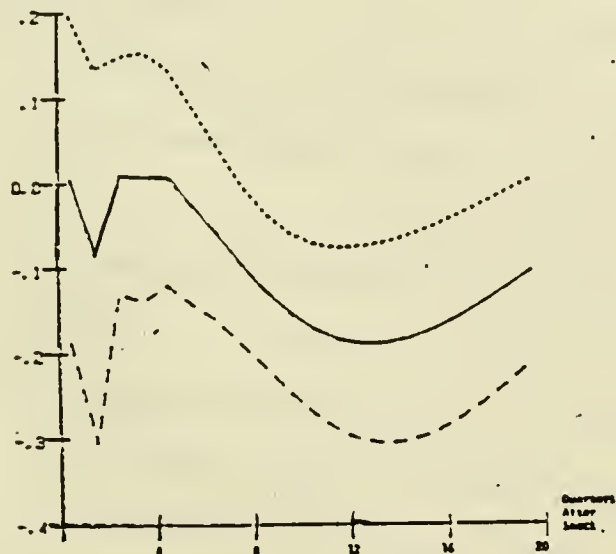


Figure II-c:  
Deviation in Output from  
Pre-Tax Level (Percent)

Figure II: Estimated Impulse Responses to a One Percent TMIX Shock  
Estimates for Great Britain based on System (9)

with the price effects in individual quarters also exceeds one for nearly four years after the tax reform.

Nominal wages also rise after the tax change. In the first quarter, they increase by nearly half a percent, raising the firm's real wage by .2 percent. The real wage increases for another quarter, and then begins to decline. By seven quarters after the tax reform, real wages have fallen below their initial level and they remain more than .1 percent below their starting point for nearly two years. The wage dynamics are not as well determined as those for prices. The sum of the wage impulses for the first five quarters after the shock is 0.985, with a standard error of 0.895. The figure also shows that the standard errors associated with the wage impulses are larger than those for prices.

The impulse response path also shows output moving erratically. However, the estimates of the output response function are imprecise. Output rises in the quarter when the shock occurs, and then declines in the next quarter. The sum of output deviations for the five quarters after the shock is -0.07 percent, with a standard error of .605. By ten quarters after the shock, the comparable value is -.310 with a standard error of .465. Six quarters after the tax shock, output enters a long period of decline. At the lowest point on its trajectory, output is .19 percent below its initial level. The individual-quarter output effects should be regarded with caution, however, as the large standard errors suggest.

The estimates from system (10) also suggest significant tax effects, as can be seen from the impulse response functions in Figure III. Prices rise by .19 percent in the quarter of the shock, forty percent of the amount which would be predicted if pre-tax prices were completely fixed. They decline slowly thereafter, and are still more than .08 percent above their initial

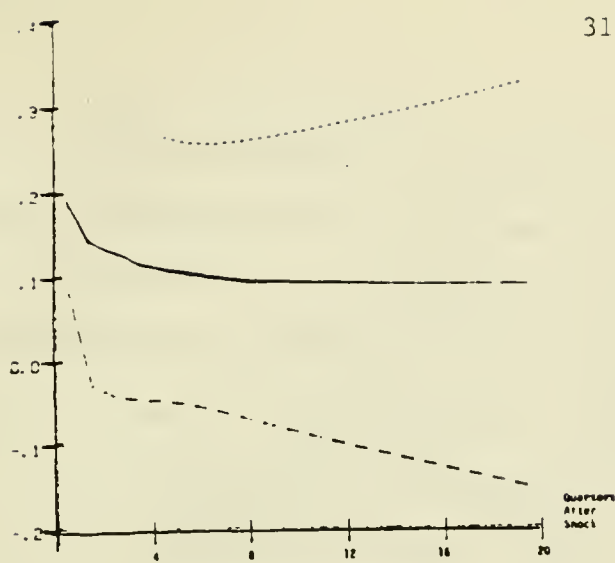


Figure III-a:  
Deviation of Prices from  
Pre-Tax Level (Percent)

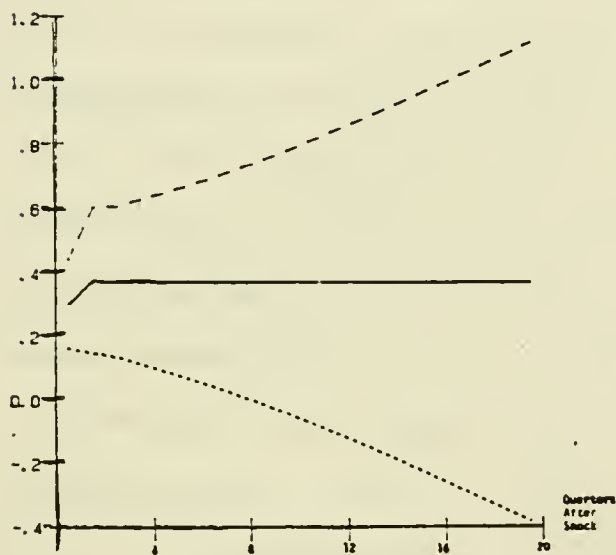


Figure III-b:  
Deviation of Real Wages from  
Pre-Tax Level (Percent)

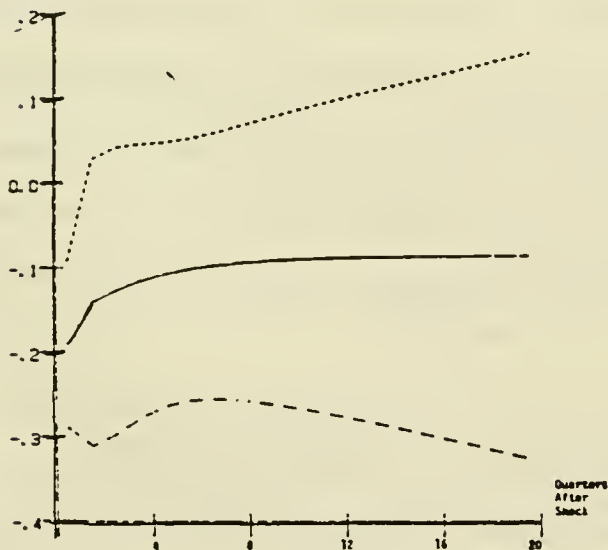


Figure III-c:  
Deviation of Output from  
Pre-Tax Level (Percent)

Figure III: Estimated Impulse Responses to a One Percent TMIX Shock  
Estimates for Great Britain based on System (10)

level four years afterwards. The standard errors for the impulse response functions from (10) are however larger than those from (9). Five quarters after the tax change, the sum of the deviation of prices from their initial level is .655 percent, with a standard error of .710. Real wages again rise for a short while after the tax shock occurs, and then decline. Output changes in this system, which are equal to the negative of the price impulses, display a more stable response pattern than those in system (9).

We explored the robustness of our tax mix results in several ways. We added exchange rates as additional explanatory variables; they had statistically insignificant coefficients and did not affect our conclusions about tax policy. We continued to reject the null hypothesis of zero coefficients on the tax mix variables at very high levels. We also estimated our equations without the indicator variables for wage and price controls, and most of the tax coefficients changed very little. Adding further lagged variables to the system reduced the statistical significance of some coefficient estimates, but had little impact on either our estimated dynamic responses or our rejections of the tax neutrality hypothesis.<sup>25</sup>

#### IV. C. United States TMIX Results

In this section, we investigate whether our U.K. findings are consistent with the U.S. experience. Appendix Table A-3 presents estimates of systems (9) and (10) using American data for the 1955:1-1984:3 period. The central question is whether we can reject the null hypothesis that TMIX should be

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<sup>25</sup>. A change in the total tax burden also has real effects. In the three-equation system, a one percent of GDP increase in the total tax burden reduces output .51 percent in the quarter of the tax change, and induces lower output for three quarters after the shock. The estimates of TTOT's impact on both prices and output, however, are plagued by very large standard errors.

excluded from these systems. For system (9), the test statistic is 21.7. Since it is distributed  $\chi^2(6)$  under the short-run tax neutrality hypothesis, this constitutes a rejection at the .01 level. For system (10), the two-equation system, the test statistic of 17.8 ( $\chi^2(4)$  under the null) also implies rejection at the .01 level. These findings provide strong evidence for the presence of wage or price stickiness in the United States. To illustrate effects which these rigidities imply for tax changes, we now consider impulse response functions for prices, wages, and output. In both systems, we clearly reject the null hypothesis that the tax mix variables have zero coefficients. The test statistics again imply rejections at the .01 level. Our discussion will focus on estimates which use the GNP deflator to measure prices. Using the shelter-exclusive CPI, however, yields even stronger rejections of the tax irrelevance hypothesis and even more pronounced price effects after a tax change.

Figures IV and V report the impulse response functions corresponding to systems (9) and (10). The initial effect of a permanent one percent TMIX increase is a .32 percent increase in prices. As in the British data, prices continue to increase for one quarter after the tax shock, and decline smoothly thereafter. The absence of significant tax variation makes the standard errors on the estimated price responses larger than those for Britain. The sum of the price changes for the first five quarters after the change is 1.130, with a standard error of 1.63. The American evidence also differs from the British in suggesting much slower adjustment back to equilibrium, as is clear from Figure IV.

Real wages also rise after a tax shock, corroborating our British findings. The initial effect of a one percent TMIX shock is to raise the firm's real wage by .44 percent. Real wages continue to increase for one

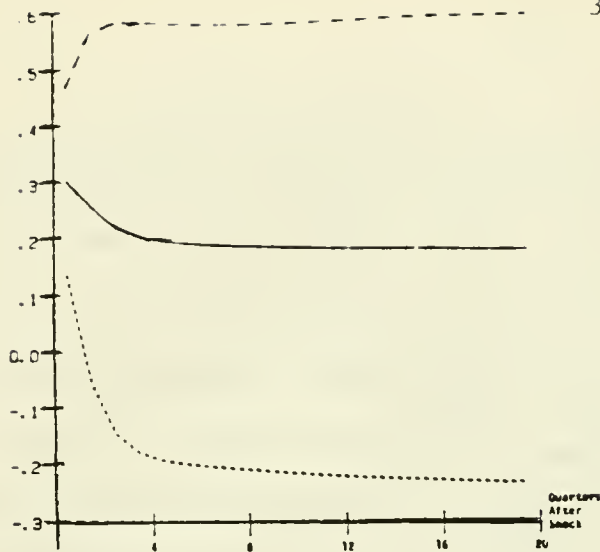


Figure IV-a:  
Deviation of Prices from  
Pre-Tax Levels (Percent)

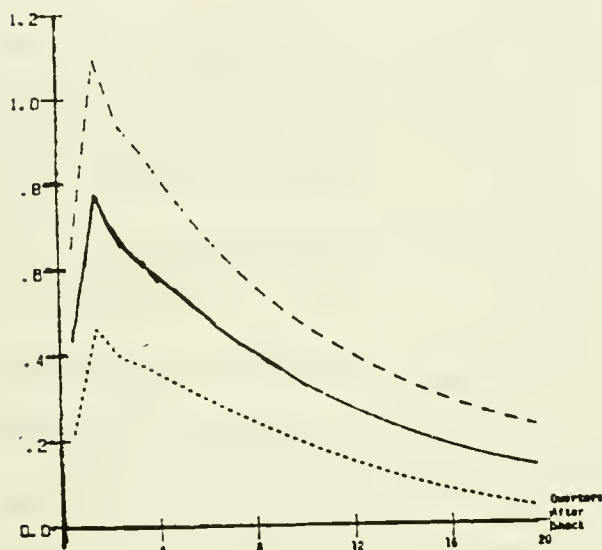


Figure IV-b:  
Deviation of Real Wages from  
Pre-Tax Levels (Percent)

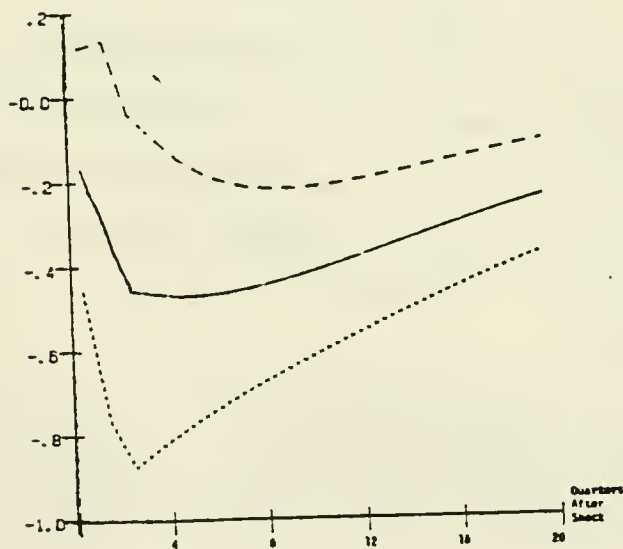


Figure IV-c:  
Deviation of Output from  
Pre-Tax Levels (Percent)

Figure IV: Estimated Impulse Responses to a One Percent TMIX Shock  
Estimates for the United States, based on System (9)

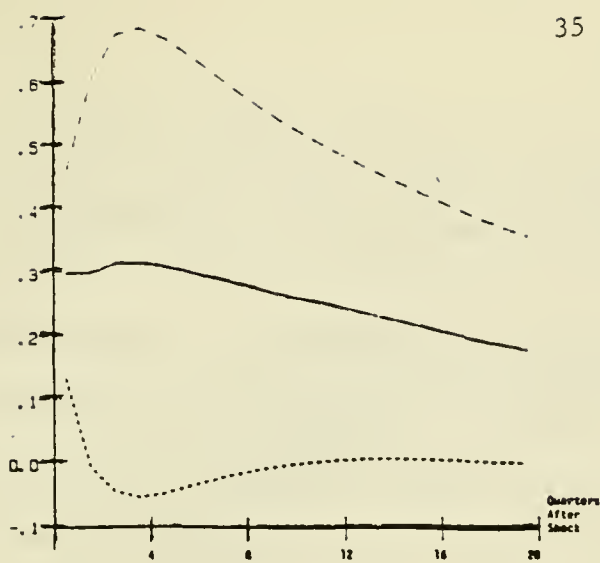


Figure V-a:  
Deviation of Prices from  
Pre-Tax Level (Percent)

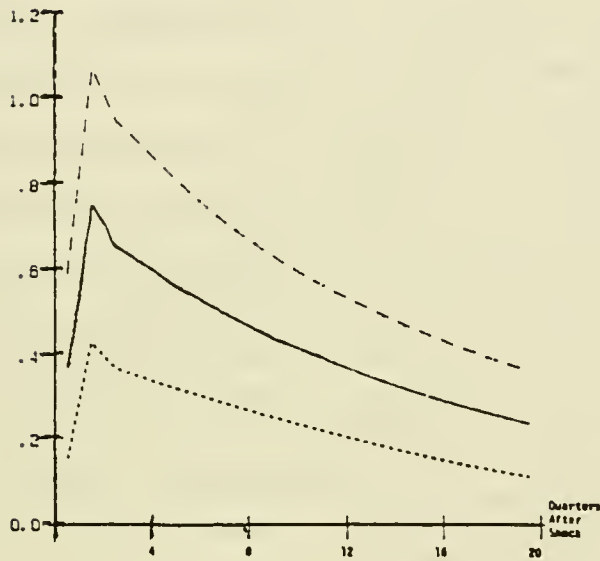


Figure V-b:  
Deviation of Real Wages from  
Pre-Tax Level (Percent)

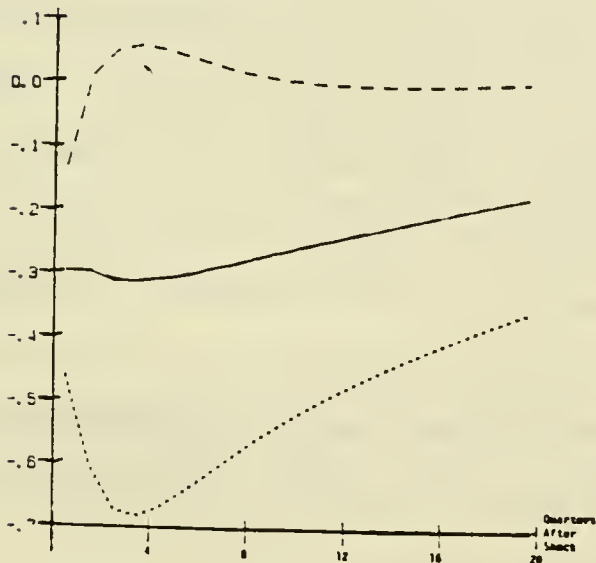


Figure V-c:  
Deviation of Output from  
Pre-Tax Level (Percent)

Figure V: Estimated Impulse Responses to a One Percent TMIX Shock  
Estimates for United States based on System (10)

additional quarter, and then decline monotonically to their initial level. Adjustment is slow; even five years after the tax shock, real wages are .13 percent above their initial level.

Output experiences a pronounced decline after an increase in indirect taxation. A one percent rise in TMIX induces a .2 percent drop in real GNP in the quarter of the tax change. The path of output thereafter depends upon the choice between systems (9) and (10). In (9), the three equation system, output continues to decline for another quarter and falls to .45 percent below its initial level before starting to return to its initial level. The sum of the output effects up to ten quarters after the change is -4.120, with a standard error of 2.731. The results for (10) suggest that the amount of lost output declines after the first quarter, although output returns to its initial level very slowly. The ten-quarter sum equals -2.903 (2.951). Both sets of results are consistent with the view that nominal wages are sticky, since the insufficient nominal wage decline in response to indirect tax increases raises real wages and induces firms to lay off workers. This has the ultimate effect of lowering real money balances.

Our findings are insensitive to several specification changes. Excluding Gordon and King's (1982) wage-price control variables has little effect on the estimated coefficients and impulse response functions. Adding interest rates, exchange rates, and further lagged values of the currently included variables also has little substantive impact on our conclusions. The central finding, that the short-run tax neutrality hypothesis is strongly rejected, obtains in a wide variety of specifications.

These results can also be used to study the impact of revenue-raising tax increases. Raising the total tax burden permanently, while keeping TMIX constant, increases prices and real wages and causes a drop in output. A one



percent increase in TTOT raises prices by .38 percent, and real wages by .26 percent, in the first quarter. Output declines by .81 percent when the shock occurs, and continues to fall thereafter. By eight quarters after the tax increase, output is 1.65 percent below its starting value. These findings, while suggestive, are accompanied by large standard errors and should therefore be interpreted with caution.

#### IV. D. Qualifications

Two potentially important assumptions underlie our use of the TMIX variable to test for the existence of nominal rigidities. First, we assume that TMIX is exogenous in our reduced form equation systems. Second, we postulate that except for the effects of wage and price stickiness, changes in TMIX should have no impact on prices or output. The possible failure of parallel assumptions has caused debate about the interpretation of linkages between money and output. We consider each assumption in turn.

Several arguments might be constructed to suggest that our tax mix variable is not exogenous. Perhaps most plausibly, it might be noted that if the output elasticities of direct and indirect taxes are different, then changes in real output will induce changes in TMIX. Price shocks may be transmitted to GNP and then to TMIX as well. This issue is partly addressed by our inclusion of lagged output in the reduced form systems, and by our separate examination of the 1979 and 1976 policy changes in Great Britain. As a further check, we use data on cyclically adjusted revenue collections<sup>26</sup>

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<sup>26</sup>. Full employment data are not available for the U.K. on a quarterly basis. In the United States, data on federal taxes beginning in 1955 are published in Halloway (1984a, 1984b). Estimates of high employment state and local receipts were constructed by the authors.

to create full employment TMIX and TTOT variables for the United States. These data were only available for the post-1955 period. The results obtained using these variables were similar to those obtained with our unadjusted tax variables, suggesting that cyclical fluctuations are not an important source of endogeneity for the receipts-based tax measures.<sup>27</sup> Unfortunately, the data are not available to examine the effects of cyclical adjustments for Great Britain, or for the entire post-1948 period in the United States.

An alternative argument against the exogeneity of TMIX might hold that the tax mix is set in response to projected economic conditions, or that it helps to forecast future economic policies. Consideration of the historical context which generated changes in TMIX does not support these views. The 1979 tax reform in Great Britain immediately followed an election which was decided on grounds other than tax policy. The avowed purpose of its proponents was to improve incentives through reductions in marginal income tax rates. In the United States, most of the variation in indirect taxes comes from movements in state sales taxes and employer payroll taxes. Neither of these are likely to be manipulated for macroeconomic purposes. More generally, it seems unlikely that governments systematically shift towards indirect taxes when they foresee rising prices, or when they intend to pursue more expansionary monetary policy. The 1979 reform in Britain was accompanied by an announced policy of monetary restraint. Nothing in the

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27. Although the results using full employment and unadjusted TMIX are always similar, the resemblance between our equations for the 1948-1984 period (reported in Table A-3) and the comparison equations for 1955-1984 depended upon our choice of price series. The equations using the shelter-exclusive CPI are very similar to those for the full sample period, while those using the GNP deflator are substantially different.

history of either British or American tax policy suggests that tax changes should help to forecast future monetary policies. This inference is consistent with the failure of Granger causality tests to reject the hypothesis that TMIX does not cause either money or TTOT.

The second potential objection to our tests is that TMIX might have effects on output and prices through channels other than wage and price rigidities. Such a possibility cannot be ruled out, since changes in TMIX do not correspond precisely to our theoretical model. Indirect taxes do not cover all goods, and direct taxes are not strictly proportional. Nonetheless, it is difficult to explain our findings along these lines. Increases in indirect taxes coupled with equal revenue decreases in direct taxes are usually thought to improve incentives to work and invest. Since indirect taxes are also less progressive than direct taxes, they should have smaller disincentive effects. Thus, they should raise output and reduce prices -- the opposite of what we find.

There are no controlled experiments in macroeconomics. Nevertheless, we find it difficult to account for our results in terms of the limitations of tax-shift experiments. At a minimum, the flaws in our tax-based tests are largely independent of those in tests which focus on the relationship between money and output. Hence, our tests provide at least some additional evidence to support the hypothesis of wage and price stickiness.

## V. Conclusions

A major thrust of much recent macroeconomic research has been the elucidation of business cycles as equilibria of competitive economies with fully flexible prices. Theories in both the "misperceptions" and "real business cycle" traditions emphasize the assumption of perfect price flexibility and the resulting absence of unexploited opportunities for beneficial exchange. These theories imply strong data restrictions: fully perceived changes in government policy which do not change any agent's opportunity set should have no real effects. In contrast, the essence of contemporary Keynesian thinking is that prices are in some sense sticky, so certain purely nominal disturbances do matter.

The difficulty in empirically distinguishing these theories arises from the problem of isolating purely nominal disturbances. Traditionally, they have been tested by examining the relationship between variously-measured monetary shocks and real variables. These tests have not been entirely conclusive because a variety of rationalizations, with very different structural implications, can be offered for the comovement of money and output.

In this paper, we rely on tax shocks of a special sort to distinguish between classical and Keynesian models. A clear implication of microeconomic theory with flexible prices is that the side of the market on which a tax is collected does not influence its ultimate real effects. Tax changes between direct and indirect taxation therefore provide a natural experiment for examining the importance of nominal rigidities. The appeal of the experiment is enhanced by the apparently unsystematic way in which taxes have varied.

The results of our investigation lead us to decisively reject the classical view that wages and prices are perfectly flexible. While arguments

may be made to rationalize the comovements we observe with perfectly flexible prices, we find it impossible to convincingly account for the empirical regularities in the data without assuming some sort of price rigidity.

Asserting that prices are rigid falls far short of explaining them or understanding their properties. Our results suggest that this remains a vitally important research problem. "Menu costs," which have been proposed as one explanation for price rigidities, cannot explain why many prices which can be changed costlessly, such as newstand magazine prices,<sup>28</sup> appear to change infrequently. Moreover, monetary policy appears potent even in highly inflationary economies, where menu costs should be less important.

Our results have potentially important consequences for tax policy. Almost universally, reforms in the tax structure are evaluated within the context of market clearing models where prices are perfectly flexible. Within such models, the distinction between direct and indirect taxation is of no consequence. Our findings suggest that this distinction may be important over periods of several years, during which prices are sticky. Indeed the macroeconomic consequences of some reforms may dwarf their microeconomic impact on economic efficiency. If unemployment is a significant byproduct of certain tax reforms, traditional thinking about their incidence needs to be reconsidered.

Consider as an example current proposals to raise revenue by taxing domestic and imported crude oil. Available estimates<sup>29</sup> suggest that this

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28. Cechetti (1984) presents detailed evidence on the inflexibility of magazine prices.

29. The Congressional Budget Office (1985) discusses this proposal.

measure would raise about 4.2 billion dollars for each one dollar per barrel tax. Thus a five dollar a barrel tax would raise the indirect tax burden by 21 billion dollars. Our estimates suggest that if monetary policy were not altered, this would result in lost output of sixty billion dollars over the succeeding decade. Similar estimates are obtained assuming that monetary policy acts to keep nominal GNP constant following the tax reform. These figures bulk large relative to allocative effects traditionally emphasized in microeconomic analyses of excise tax reforms. Proposals to tax only marginal suppliers of goods, such as the proposed surtax on oil imports, would have much greater output effects per dollar of revenue raised.

Some might argue that it is inappropriate to assess the output effects of tax reforms while holding monetary policy constant, since monetary policy could accommodate tax changes. This issue is treated in Poterba, Rotemberg and Summers (1985). Note, however, that if the monetary authority has set monetary policy to trade off unemployment and inflation in a desirable way prior to tax reform, the loss of welfare from a small tax change will be independent of the monetary policy response. Unless one believes that monetary policy is wrong prior to a tax reform, there is no reason not to evaluate the effects of the tax holding monetary policy constant. This is especially true for small reforms such as the gasoline tax. It is also inconceivable that the effects of small reforms could be disentangled accurately enough for them to be explicitly accommodated by monetary policy.

Our finding that shifts towards indirect taxation have adverse macroeconomic consequences raises an obvious question. Could macroeconomic performance be improved by reducing indirect taxes and increasing direct taxes? The conscious and regular use of such tax policies as stabilization measures would be such a significant change in policy regime that our

estimates cannot shed much light on this issue. However, they do suggest that such a change might well be desirable on a one-shot basis. The gains might be taken either in the form of reduced inflation or increased output. Poterba, Rotemberg and Summers (1985) demonstrate that if output is held constant, tax changes may well have a permanent effect on the rate of inflation.

Our results suggest a number of directions for future research. The robustness of our conclusions might be examined by studying tax changes in other countries or in individual American states. Structural estimation might yield more precise information on the nature of wage and price stickiness, and tax reforms might facilitate identification of these models. The effects of alternative policy responses to large tax reforms might also be considered. Perhaps most importantly, our results isolate a major class of apparent rigidities which economic theory needs to explain.

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APPENDIX

This appendix demonstrates the widespread applicability of the neutrality results discussed in Section I. First, we show that value added taxes and income taxes are equivalent in a multiperiod economy when there are only spot markets for consumption and capital. At time  $t$ , households can purchase a consumption vector  $C_t$  and claims on  $K_t$  units of capital. Firms receive a price  $p_t$  for consumption goods, and  $q_t$  for a new unit of capital. Households receive income from the capital and labor they supply to firms. Each claim on capital purchased at  $t$  pays  $r_{t+1}$  of "interest income" at  $t+1$ , and becomes a claim on  $(1-\delta)$  units of capital at  $t+1$ . Households supply  $L_t$  units of labor and firms pay a wage  $w_t$  per labor unit.

The government taxes all value added at rate  $\theta$ , so households must pay  $(1+\theta)p_t$  for consumption goods and  $(1+\theta)q_t$  for claims on capital. Investment goods are not exempt from the VAT; exempting them would be equivalent to an investment tax credit. Households pay income taxes on the wages and interest income which they receive, but there is no capital gains tax. The household's budget constraint at  $t$  is therefore:

$$p_t \cdot C_t + q_t K_t = (w_t L_t + r_t K_{t-1})(1 - \tau)/(1 + \theta). \quad (\text{A.1})$$

Relative prices at time  $t$ , and government revenue, depend only on  $(1-\tau)/(1+\theta)$ . We must also show that intertemporal prices depend only on the tax factor  $(1-\tau)/(1+\theta)$ . By foregoing one unit of a good with price  $p_{it}$  at  $t$  and  $p_{it+1}$  at  $t+1$ , buying claims on capital, and consuming the proceeds at  $t+1$ , the household obtains  $(p_{it}/p_{it+1})(r_{t+1} + (1-\delta)q_{t+1})/q_t$  units of the good at  $t+1$ . This depends only on  $\delta$  and the prices facing firms, which depend

only on  $(1-\tau)/(1+\theta)$ . This completes the demonstration of equivalence.

Second, we show the equivalence between sales and income taxes in an economy with complete contingent claims markets, as in the real business cycle literature (Long and Plosser (1983), for example). Goods are indexed by time and state of nature. Suppose that all trade is intermediated by firms, which charge prices  $P$  for the goods they sell. The vector of household purchases is  $Q$ , while the vector of household sales to firms is  $V$ . Let  $W$  be the vector of prices the firms pay the households for the goods they purchase. We consider an income tax  $\tau$  levied on all state contingent sales by households, and a sales tax  $\theta$  levied on all state contingent sales by firms. The household's lifetime budget constraint can then be written as  $(1 + \theta)P \cdot Q = (1 - \tau)W \cdot V$ . Firm's decisions depend only on  $P$  and  $W$ , while household's actions depend on  $P$ ,  $W$  and  $(1-\tau)/(1+\theta)$ . To show that sales and income taxes are equivalent it therefore suffices to show that government revenue also depends only on  $(1-\tau)/(1+\theta)$ . Tax receipts from the private sector equal  $T = \theta P \cdot Q + \tau W \cdot V$ , which may be written as

$$T = \left[ \theta \frac{(1-\tau)}{(1+\theta)} + \tau \right] W \cdot V = \left[ 1 - \frac{(1-\tau)}{(1+\theta)} \right] W \cdot V. \quad (A.2)$$

This completes the equivalence proof.

This result generalizes to an economy in which sales and income taxes are not levied on all state contingent transactions, but only on those transactions which take place after states of nature are realized, under two conditions. First, there must be a complete set of Arrow-Debreu securities which pay one dollar at time  $t$  if state  $s$  is realized. Second, the "income" from these securities must be untaxed. A more detailed discussion is available from the authors on request.

Table 2. (t-ratios, degrees, Durbin, and White in Serial Correlation, After the 1979 Oil Shock

Eq.	Variable	Constant	Period(-1)	Eq(-2)	Eq(-1)	Durbin(-1)	Durbin(-2)	Portia(-1)	Portia(-2)	White(-1)	White(-2)	White(-3)	Durbin(-1)	Durbin(-2)	Durbin(-3)	White(-1)	White(-2)	White(-3)	
1a	R116 (Barometer)	-1.166 (-1.062)	1.142 (1.162)	-0.179 (-1.139)	0.329 (1.100)	-0.109 (-1.100)	0.294 (1.064)	-0.094 (-1.094)	-0.019 (-0.119)	0.049 (1.049)	-0.073 (-1.073)	0.119 (1.119)	-0.022 (-0.122)	0.016 (1.016)	-0.023 (-1.023)	0.016 (1.016)	-0.023 (-1.023)	0.016 (1.016)	0.024 (1.024)
1b	Rate	1.130 (1.130)	1.130 (1.130)	-0.179 (-1.139)	0.329 (1.100)	-0.109 (-1.100)	0.294 (1.064)	-0.094 (-1.094)	-0.019 (-0.119)	0.049 (1.049)	-0.073 (-1.073)	0.119 (1.119)	-0.022 (-0.122)	0.016 (1.016)	-0.023 (-1.023)	0.016 (1.016)	-0.023 (-1.023)	0.016 (1.016)	0.024 (1.024)
1c	Output	1.012 (1.012)	1.012 (1.012)	-0.179 (-1.139)	0.329 (1.100)	-0.109 (-1.100)	0.294 (1.064)	-0.094 (-1.094)	-0.019 (-0.119)	0.049 (1.049)	-0.073 (-1.073)	0.119 (1.119)	-0.022 (-0.122)	0.016 (1.016)	-0.023 (-1.023)	0.016 (1.016)	-0.023 (-1.023)	0.016 (1.016)	0.024 (1.024)
2a	Rate	1.259 (1.259)	1.259 (1.259)	-0.179 (-1.139)	0.329 (1.100)	-0.109 (-1.100)	0.294 (1.064)	-0.094 (-1.094)	-0.019 (-0.119)	0.049 (1.049)	-0.073 (-1.073)	0.119 (1.119)	-0.022 (-0.122)	0.016 (1.016)	-0.023 (-1.023)	0.016 (1.016)	-0.023 (-1.023)	0.016 (1.016)	0.024 (1.024)
2b	Output	1.012 (1.012)	1.012 (1.012)	-0.179 (-1.139)	0.329 (1.100)	-0.109 (-1.100)	0.294 (1.064)	-0.094 (-1.094)	-0.019 (-0.119)	0.049 (1.049)	-0.073 (-1.073)	0.119 (1.119)	-0.022 (-0.122)	0.016 (1.016)	-0.023 (-1.023)	0.016 (1.016)	-0.023 (-1.023)	0.016 (1.016)	0.024 (1.024)
3a	Rate	1.079 (1.079)	1.079 (1.079)	-0.179 (-1.139)	0.329 (1.100)	-0.109 (-1.100)	0.294 (1.064)	-0.094 (-1.094)	-0.019 (-0.119)	0.049 (1.049)	-0.073 (-1.073)	0.119 (1.119)	-0.022 (-0.122)	0.016 (1.016)	-0.023 (-1.023)	0.016 (1.016)	-0.023 (-1.023)	0.016 (1.016)	0.024 (1.024)
4a	Rate	0.293 (0.293)	0.293 (0.293)	-0.179 (-1.139)	0.329 (1.100)	-0.109 (-1.100)	0.294 (1.064)	-0.094 (-1.094)	-0.019 (-0.119)	0.049 (1.049)	-0.073 (-1.073)	0.119 (1.119)	-0.022 (-0.122)	0.016 (1.016)	-0.023 (-1.023)	0.016 (1.016)	-0.023 (-1.023)	0.016 (1.016)	0.024 (1.024)
4b	Rate	0.293 (0.293)	0.293 (0.293)	-0.179 (-1.139)	0.329 (1.100)	-0.109 (-1.100)	0.294 (1.064)	-0.094 (-1.094)	-0.019 (-0.119)	0.049 (1.049)	-0.073 (-1.073)	0.119 (1.119)	-0.022 (-0.122)	0.016 (1.016)	-0.023 (-1.023)	0.016 (1.016)	-0.023 (-1.023)	0.016 (1.016)	0.024 (1.024)

Notes: All equations are estimated by ordinary least squares for the period 1963:3-1983:4, a total of 82 observations. Standard errors are shown in parentheses. Q(4) is a four-quarter Box-Ljung test against the presence of residual autocorrelation. See text for definition of variables.



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