REFLECTIONS ON FISCAL POLICY

E. Cary Brown

Number 240 May 1979
REFLECTIONS ON FISCAL POLICY

E. Cary Brown

Number 240 May 1979
REFLECTIONS ON FISCAL POLICY

E. Cary Brown *

The repute and apparent effectiveness of fiscal policy have both fallen a long way from peaks reached in the mid 60's. Policymakers no longer regard fiscal policy as an effective device for fighting inflation and analysts have questioned its overall effects. The present economic structure seems profoundly different from that of earlier decades and much less receptive to the macroeconomic policies that worked then. Indeed, some write off fiscal policy completely as of no consequence for stabilization policies.

It would be delightful to put forth a solution to these difficulties: an overlooked synthesis, a new fiscal instrument. This chapter, however, will only review some of the major steps that brought fiscal policy to its present stage and consider further some of its major criticisms.

MAJOR DEVELOPMENTS IN FISCAL POLICY

Before World War II the economic profession disagreed about the capacity of expansive fiscal action to increase income and employment. Policy discussion mirrored that confusion. Many regarded budget deficits as contractionary, not the other way round. Wartime advances in national-income accounting coupled with advances in macro-theory, particularly the discussion of the balanced-budget multiplier, clarified the difference between the impact of taxes on national income and that of government purchases, effectively eliminating the budget deficit as a determinant of income.¹

*Professor of Economics, Massachusetts Institute of Technology. To appear in the Festschrift to Joseph A. Pechman.
The Early Postwar Period

A second major step in the post war development of fiscal-policy theory was the incorporation of automatic stabilizers into the analysis. Ultimate acceptance of automatic stabilizers for policy purposes depended on the observed fact that resources in the postwar economy were being reasonably fully employed, not, as in the prewar period, seriously underemployed. Full-employment fluctuations rather than stagnation seemed the major stabilization problem, and automatic stabilizers could contribute to such a problem.

During the Korean War fiscal policy was timely and effective. Tax policy was implemented so rapidly that large budget surpluses arose in the first year of war mobilization. Three major tax bills passed Congress within a year and a half of the opening of hostilities. In contrast with World War II when, to be sure, the degree of resource mobilization was many times greater, fiscal policy during the Korean War carried the major burden of stabilization, with some backup from direct controls.

By the end of the war, the economics profession, with few exceptions, agreed on the efficacy of fiscal policy. Economists no longer feared a recurrence of a depression and stagnation such as bedevilled the 1930s. Nevertheless, no U.S. government had yet changed taxes, without making a similar change in purchases, solely for stabilization purposes.

The 1964 Tax Cut

The 1964 tax cut has been regarded rightly as one of the great
successes in the use of fiscal policy to stabilize the economy. But incorporation by the Administration of major tax reform proposals into the proposed stabilizing tax reduction caused long drawn-out debate. Only a stripped-down version of the original program providing for tax reduction and virtually no tax reform eventually passed, and even that came only upon President Johnson's special request following the assassination of President Kennedy.

The sluggish enactment of the 1964 legislation pointed up again the potentially long lag in the operation of fiscal policy. The dangers of such delay had been known for some time. Some students of the fiscal process attributed the delay to the attempts to achieve several objectives with one piece of fiscal legislation: reform of the tax system and changes in total taxes; adjustments in the distribution of income and modification of aggregate demand. Some analysts argued that Congress could act promptly if simple temporary fiscal changes were requested for stabilization purposes alone the form of which was agreed to in advance. Others proposed to reduce or eliminate this inside lag by requesting Congress to authorize the Executive to vary tax rates around a permanent rate structure. President Kennedy asked for such authority, but Congress ignored his request.

President Johnson did not resubmit this Kennedy proposal but instead asked Congress to examine its procedures to see if rapid fiscal action could be achieved. The Joint Economic Committee asked for the development of a standby tax program that could be rapidly
implemented by congressional and presidential action. Its Subcommittee on Fiscal Policy held hearings in 1966 and issued a report that called for enactment of standby tax changes in the form of uniform percentage increases or decreases in income tax liabilities, unconstrained in amount or time. When the situation called for tax changes, Congress could vote on a particular percentage change without having to debate the distribution of it. The ground work had been laid for prompt Congressional response to Presidential requests for fiscal action.

The 1968 Surcharge

The debate on the tax surcharge of 1968, a proposal designed to cut back aggregate demand, was a turning point in the postwar discussion of fiscal policy. The Administration proposed a tax surcharge in 1967 precisely in the form recommended by the Joint Economic Committee's Subcommittee as the least controversial for prompt enactment. Ironically, it was not until mid-1968 that Congress enacted the surtax and only then after combining it with legislation limiting certain expenditures. What went wrong? The proposed tax increase was presented in a form designed to forestall arguments over other kinds of tax changes and, implicitly, over the distribution of income. Instead, an unforeseen argument arose - over the best use of society's resources. Some opposed the surtax because they feared it advanced a repugnant war effort. Others opposed it because they thought the surtax would permit the continuation or expansion of Great Society programs that they regarded with distaste. The latter group scored a complete victory, combining
expenditure limitations that excluded war outlays with the surtax legislation. This debate was not over stabilization at all, although it sometimes masqueraded as such, but it delayed the tax bill at a time crucial for successful stabilization policy.

The 1968 experience contrasts sharply with that of the Korean War. Even though mobilization in the Vietnam War was not as great, tax increases were slower and smaller than during the Korean War. As a result the federal budget was in deficit during the Vietnam build-up while it had been in surplus during similar stages of the Korean War. Thus, sharp increases in demand added to price inflation and to the inflationary expectations that have plagued us ever since.

The Vietnam surtax was not only slow in coming, but also temporary, The effectiveness of temporary taxes was argued then and has received much attention since. In addressing this important issue one should not lose sight of the Congressional failure to act promptly on urgent stabilization legislation.

EFFECT OF TEMPORARY VERSUS PERMANENT TAX CHANGES

The inadequate response of consumer demand to the tax surcharge of 1968 raised questions about consumers' response: did they view the tax change as temporary or permanent? If temporary, how did it affect their spending decision? Many recent studies have addressed these important issues for fiscal policy. On balance this quantitative work supports the view that the temporary surtax of 1968 (and similar changes) had a noticeable effect, but about half that
expected from permanent tax changes. Some have expressed the view that such results largely eliminate temporary income tax changes from consideration as stabilization devices and require their replacement by temporary changes in consumption or investment taxes. My own view, however, would be that this finding only indicates the need for twice as large a swing in so-called temporary income taxes, not an abandonment of their use, when they have other desirable stabilizing characteristics.  

This general conclusion requires a number of qualifications.

Dogmatic conclusions about consumer response to tax changes seem unwarranted because tax changes have been few and small, particularly since 1954. In this period income-taxes were reduced in 1964, 1965, 1970, 1975, and 1978 and increased in 1968. This is sparse evidence on which to base conclusions about the effects of tax changes on consumer expectations.

The standard practice of treating all income tax changes as the equivalent of negative income may never have been wholly satisfactory. Furthermore, the use of an adaptive expectation model to arrive at estimates of long-run disposable income implied that consumers were forming their expectations about income and taxes in the same way. Whether or not this assumption is valid should surely be tested. The most recent major study of the effects of temporary taxes by Modigliani-Steindel has the merit of separating income and taxes making it possible to detect a difference in consumer expectations about them.

While this separation of taxes from income is a desirable step in analysis, the drawing of a sharp division between temporary and permanent
taxes is unsatisfactory, because of its nonexistence. So much of the recent discussion operates in an unrealistic binary world where tax changes are either temporary and treated one way by consumers, or permanent and treated in another way.\textsuperscript{22} Even the discussion of the reasons for separating income and taxes in as sophisticated a discussion as that of Modigliani and Steindel echoes this binary view when they write: "This traditional approach implicitly assumes that consumers form expectations about future tax liabilities by using the same distributed lag of past tax liabilities that they use to estimate permanent gross income from past gross income. It implies that they respond to a change in income resulting from a permanent tax change in the same way they respond to variations in before-tax income, which presumably are partly transient. It is clearly a questionable assumption."\textsuperscript{23}

This dichotomy is fictional. Surely Congress can extend, and has extended, "temporary" legislation. It can also modify "permanent" legislation annually, if it so desires. The issue comes down to expectations of consumers about taxes, not those of members of Congress or of economists and especially not those of economists formed after the fact. Therefore, there must surely be a changing component in taxes just as there is in income which requires some kind of adaptive adjustment similar to the adjustment to income before taxes.\textsuperscript{24} Okun has provided a number of examples of the difficulty of sorting out permanent and temporary fiscal changes,\textsuperscript{25} and I would like to add some more.

The case could be made that a permanent rate structure was enacted in 1944\textsuperscript{26} that continued unchanged through 1963, that all intervening
changes were temporary deviations from that rate structure, expressed as percentage reductions or additions to it. In 1944 and 1945, this rate structure was fully applicable. It was reduced by 5 percent in 1946 and 1947, by about 12 percent in 1948 and 1949, and by about 4 percent in 1950. Tax liabilities computed under this rate structure were increased about 2 percent in 1951, and 11 percent in 1952 and 1953. In 1954 through 1963 this rate structure was again fully applicable. It is hard to believe that consumers considered each of these tax changes as permanent ones, especially in the early part of the period, although each was embodied in "permanent" legislation. Yet, the analysis of this period would be profoundly affected by treating these tax changes as temporary adjustments to a permanent rate structure rather than as permanent changes.

On the one hand, since the rate structure remained on the statute books for nineteen years, the deviations expressed as percentages from it enacted in 1945, 1947, 1950, and 1951 could have appropriately been called temporary. Something of the order of 1/4 of 1 percent of GNP in 1946-47, and of 1 percent of GNP in 1947-49 would, under this assumption have been treated as temporary tax reduction. (The reader may be reminded that the order of magnitude of the latter at the present time would be a $20 billion temporary tax reduction). The tax structure would have been considered much less expansionary than it in fact appeared to be. The 1950 rate structure was 4 percent below the permanent structure (1/4 of 1 percent of GNP), and the 1951-53 structure about 11 percent above the permanent structure (about 1 percent of GNP).
Both would have been considered less deflationary than nominal tax receipts would indicate.

On the other hand, the public, conditioned by the Depression and World War II, periods in which temporary changes became permanent and vice versa, may have regarded each new tax structure as about as permanent as any other. An agnostic view would have treated each change as a continuing one until further notice, adjusting expenditure each time on the assumption of continuity. Earlier studies found such an assumption to be a reasonable explanation of consumer behavior in this period. 29

There are other interesting fiscal puzzles that have not been sufficiently noticed. The temporary tax increase of 1968 was effective for 21 months at a 10-percent rate, and was later extended for 12 months more at one quarter the rate. 30 The Revenue Act of 1951 provided the equivalent of a surcharge of 11 percent for 26 months, 31 a shorter period of time than in 1968-70. Although monetary policy was essentially permissive at that time in contrast to the later period, consumers appeared to respond more fully to the 1951 change than to the 1968 change. Apparently, the public in 1951 continued to believe that temporary legislation might not mean temporary taxes, as in World War II.

Finally, how does one deal with legislation of future increase of exemptions scheduled in 1969 (and updated by later legislation), the future increases in capital gains taxes of
1976? Do consumers react to them immediately? Those who are interested in consumer response to tax manipulation are obliged to answer these questions. They cannot be solved theoretically, and the solutions must explain consumer response to an uncertain future.

**TAXES ON OUTLAYS**

Faced by the problems of implementing stabilization policies through income tax changes, some have shifted their attention to taxes on consumer and business expenditure. Temporary changes in such taxes are designed to induce consumers or business firms to change the timing of expenditures in a way that contributes to the stability of the economy. If taxes on, say, durable goods are temporarily raised now, and if consumers believe the tax increase will be temporary, and if they expect durable goods prices after the tax returns to its former level to be lower than at present including the tax increase, they are likely to postpone or, at least, slow down purchases of the commodity. This view lay behind some of the modest excise taxes enacted in World War II and the Korean War, and also behind the manipulation of the investment tax-credit. Notice that economic units must expect the tax increase to be temporary and, if temporary, that prices will be lower after the tax is rescinded. How would we expect them actually to respond when faced by such increases? They would certainly have to take into account the history of "temporary" excise tax changes.

Temporary excise taxes in World War II, such as on durable goods and on "luxuries," continued into the postwar period despite provision for
automatic repeal at \( \wedge \) of hostilities. The initial purpose of the auto excise, for example, was to shift demand from the war to the postwar period. After the war, however, shortages appeared and the tax was continued. Congress raised it "temporarily" in the Korean War with a terminal date of March 31, 1954, but extended it annually thereafter at the higher rate until 1965 when provision was made for its phasing down to 1 percent over a four-year period. But in 1966 these downward steps were eliminated in the face of the Vietnam War mobilization. Congress repealed the tax in 1969, with an effective date in 1974, later rolled back to 1971. The reader is asked to decide whether this tax was permanent, temporary, or both at different times (and, if the last, when was it regarded as permanent and when temporary).

For maximum economic effect from temporary taxes on expenditures, one would want, in general, to impose taxes on goods with substantial potential intertemporal substitution — durable goods, typically. The targeted industries are generally averse to becoming economic counterweights, and inhibit flexibility and timing through intense lobbying pressure. It is difficult for them to understand why reductions in demand should be forced on their products to make way for booming demands in other industries. Nevertheless, the broader the tax base the smaller the opportunity for intertemporal substitution among expenditures and the larger its income effect becomes. In the extreme case, the aggregate fiscal consequences of an expenditure tax differ from those of an income tax only to the extent that savings decisions are affected by the choice. If an expenditure tax is temporary,
moreover, it raises the current cost of necessities and is likely to be viewed as inequitable.

Finally, one should not gloss over the technical problems connected with spending-tax manipulations. Congress must enact any tax change proposed by the executive and such enactment takes time. During such delays, transient speculative demand counters the intent of the fiscal change. This delay may be brief or protracted. Certainly manipulation of commodity tax rates, if believed to be desirable policy, should be a strong candidate for limited Presidential discretion.

A second set of technical problems stems from the lengthy production and delivery process of many goods, especially custom durables, and from the desire to deal fairly yet effectively with the decisions of economic units. To what extent, for example, should existing contracts be modified by tax changes? These problems are manifest in starting and stopping the investment tax credit. If it is desirable to reduce pressure on demand, increased taxes should be imposed on orders, not on deliveries, but orders can be readily manipulated. Imposing tax changes on deliveries, on the other hand, is easier but arguably unfair, because it arbitrarily changes a price previously agreed to. To avoid such inequities, Congress usually permits the taxpayer tax reductions on all deliveries, but imposes tax increases only on deliveries ordered before the tax increase. For the usual consumer goods, the production process would not be as lengthy and the difficulties considerably less than for the investment tax credit,
yet the stabilization problems are qualitatively of the same type.

CONCLUSIONS

These reflections lead to the following conclusions.

First, temporary income tax changes remain viable instruments for stabilization. The weight of evidence supports the view that they are about half as effective as permanent tax changes. To achieve a given effect, therefore, temporary rate changes must be roughly twice as large as permanent tax changes.

Second, we are a long way from knowing how consumers form expectations about taxes and incorporate them into their expectations of permanent disposable income. Research is difficult because tax substantial changes are infrequent. But there is room for improvement in the modelling of consumer behavior with existing information.

Finally, should it be desirable to add the manipulation of spending taxes to the stabilization armory, a number of difficulties would have to be overcome. Narrow based taxes, while more effective in shifting demand, are limited in the timing and amount of rate change because of pressures from the targeted industries; broadbased taxes are politically limited in the extent of rate change because of hardship cases. Spending taxes are most effective in causing consumers to defer expenditures if they are believed to be temporary; unfortunately, temporary excise taxes have frequently turned out to be permanent.
FOOTNOTES


14. "Many of us questioned the surcharge as a device to fight inflation on a number of grounds, some political-economic, some frankly political ... We felt that the main forces pushing toward inflation were the government expenditures for the war." Robert Eisner, "Comments and Discussion of Arthur M. Okun, 'The Personal Tax Surcharge and Consumer Demand, 1968-70'," Brookings Papers on Economic Activity, 1:1971, p. 207. See also his earlier, op. cit. (1969).
15. Government purchases for national defense represented 4.8 percent of GNP in the third quarter of 1950 as compared with 7.5 percent in the first quarter of 1966. They rose to a peak of 13.5 percent of GNP during the Korean War, and 9.1 percent in the Vietnam War. By the second quarter of 1951 they had nearly doubled to 9.4 percent, yet the budget surplus in that quarter was 2.6 percent of GNP. In the comparable period of four quarters in 1966, national defense purchases had risen to 8.4 percent and the budget deficit was 0.8 percent of GNP. U.S. Department of Commerce, National Income and Product Accounts of the United States, 1929-74.

16. Earlier writers had warned of this possibility, but may have been too casual in treating all earlier tax changes as permanent. For example, Albert Ando and E. Cary Brown, "Personal Income Taxes and Consumption Following the 1964 Tax Reduction" in Albert Ando, et. al., eds., Studies in Economic Stabilization (Washington, D.C.: The Brookings Institution, 1968) write: "In an earlier article (Ando and Brown, "Lags in Fiscal Policy" in Fiscal and Debt Management Policies, Research Study for the Commission on Money and Credit (Englewood Cliffs, N.J.: Prentice-Hall, December 1963), p. 126), we tentatively concluded that the responses of consumers to changes in disposable income consequent upon tax changes do not differ materially from those consequent on changes in income before tax. This conclusion is restricted to tax changes which consumers believe to be permanent. We cannot say anything about
temporary, short-run tax changes simply because there has not been any experience with them."

Eisner, op. cit., (1969), was one of the first to spell this issue out, although he initially confused consumption and consumer expenditure.


19. This warning would apply to Modigliani and Steindel (but they were primarily interested in the tax changes of the 70's); Franco Modigliani, "Monetary Policy and Consumption," in Consumer Spending and Monetary Policy: The Linkage (Boston: Federal Reserve Bank of Boston, 1971); and Okun. Springer starts in 1948-4, and Darby and Ando-Brown in 1947-1.

20. For an earlier test of this hypothesis, see note 16 infra.

22. For example, "(W)hat may we really expect, in the light of the 'permanent-income theory,' from a temporary change in income tax rates such as those of the surcharge enacted in 1968?"

Robert Eisner, "What Went Wrong?" Journal of Political Economy, Vol. 79 (May-June 1971), p. 632 (Italics added). "(T)ax withholding was reduced...in a change that was legislated as temporary but that many expected to be permanent." Modigliani and Steindel, op. cit., p. 179.

23. Ibid., p. 190.

24. Experience in following tax legislation makes me wary of any description of legislation changes as permanent or temporary, no matter in what form they may be legislated.


26. Revenue Act of 1943, as modified by the Tax Simplification Act of 1944.

27. The remarks apply only to the rate structure. Substantial changes in the tax base were provided in the Revenue Act of 1945 and 1948. In the former case, the Victory tax was also eliminated. In the second, exemptions were increased from $500 to $600 and income splitting was permitted for all married couples.

28. Provided by a three-bracket percentage reduction system, varying inversely from 17 to 10 percent with size of tax liabilities.

30. The surtax extension to June 30, 1970 has been described as for 6 months at a 5 percent rate. Since individual income tax returns are not filed semiannually, and since most taxpayers are on a calendar year basis, the extension was for 12 months at a 2 1/2 percent rate.

31. Had Representative Reed, the new Republican chairman of the Ways and Means Committee, been successful, the cut-off date would have been moved back half a year. Again, the effective date would have been the same, but the rate would have been halved.

32. Even Eisner's critique op. cit. (1969), pp. 904-5 contains these well known proposals. See also Modigliani and Steindel, op. cit., p. 201, and Tobin, op. cit., Chapter 5.

33. For thorough discussion of these issues, see John Litner, "Do We Know Enough to Adopt a Variable Investment Tax Credit?" in Credit Allocation Techniques and Monetary Policy (Boston: Federal Reserve Bank of Boston, 1973).