

## THE FISCAL-MONETARY POLICY MIX

The Economic Recovery Tax Act of 1981 is expected to boost economic growth by stimulating consumer demands and raising incentives to save and invest. The saving and investing effects may take longer to develop, but they are nonetheless important because an increased capital stock is fundamental to economic growth and productivity. This policy is not expected, however, to have a large effect on inflation over the next few years. Its longer-term effects on inflation are also expected to be quite modest. Thus the current strong inertia in wages and prices, as detailed above, will continue to be an important policy problem over the first half of the decade.

Over the next few years, the thrust of monetary policy is expected to be exactly opposite to that of fiscal policy. High real interest rates are expected to restrain the growth in consumer spending, especially for housing and durable goods. Weak consumer demand results in excess capacity, which in turn discourages investment. High interest rates are also expected to exert a powerful restraining effect on investment. There is a considerable risk that tight credit conditions will offset the investment incentives of the act. To the extent that this occurs, the prospects for substantial increases in productivity and economic growth will be greatly diminished.

### The Fiscal Stimulus

The recently enacted tax changes are more forward looking than most tax changes in recent experience. The tax package was designed to increase the economy's capacity to produce. Its "supply side" incentives are of two general types: first, those that are intended to increase labor supply and work effort; and second, those that are intended to encourage saving and investment.

Labor Supply. The reductions in marginal income tax rates, and the indexation of tax rates beginning in 1985, may be expected to increase labor supply to some degree. Empirical studies suggest that the largest response occurs among females and second family earners. The response of male heads of families to lower marginal rates is apparently quite small. The overall response--either in hours worked or in labor force participation rates--is difficult to

estimate, though most studies suggest it is not large. <sup>25/</sup> Moreover, projections of personal income tax rates indicate that many wage earners may experience little or no reduction in their marginal rates during the next few years (see Chapter II). Thus estimates of very large responses in labor supply do not seem warranted. <sup>26/</sup>

Saving. The Tax Act of 1981 includes measures that may significantly increase the private saving rate. First, the act contains several special saving incentives, such as liberalized individual retirement accounts or IRAs, tax-exempt savings certificates and dividend reinvestment plans for holders of utility stocks. Second, the cut in marginal income tax rates may lead to more saving because it raises the after-tax return. In particular, it reduces the maximum tax rate on investment income from 70 percent to 50 percent--or by almost 30 percent. Third, its proportionate cut in tax rates raises after-tax incomes more for higher- than for lower-income taxpayers, and higher-income persons may have higher saving rates. Finally, the higher real after-tax interest rates stemming from a tight monetary policy should provide an incentive to save more and consume less than in the past.

Considerable uncertainty remains as to the size of the act's impact on personal saving. For one thing, most studies report small or ambiguous changes in saving in response to changes in the

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<sup>25/</sup> Two recent summaries of these studies are to be found in: Congressional Budget Office, An Analysis of the Roth-Kemp Tax Cut Proposal (October 1978), and Don Fullerton, "Can Tax Revenues Go Up When Tax Rates Go Down?," Office of Tax Analysis, Paper #41, Treasury Department, Washington, D.C. One recent empirical study, however, reports somewhat larger supply effects than most previous studies. See: J. Hausman, "Labor Supply," in H.J. Aaron and Joseph A. Pechman, eds., How Taxes Affect Economic Behavior (Brookings, 1981), pp. 27-84, and J. Hausman, "Income and Payroll Tax Policy and Labor Supply," in L.H. Meyer, ed., The Supply-Side Effects of Economic Policy, (Center for the Study of American Business, 1981), pp. 173-202.

<sup>26/</sup> There is the related issue that high marginal tax rates encourage tax avoidance, some of which may be reduced by the tax cut.

after-tax return on saving. 27/ For another, some analysts expect that a significant portion of the funds deposited in IRAs or in tax-exempt savings certificates will come from some other form of saving rather than from an increase in the saving rate. Even so, for most taxpayers, the existence of a tax-free saving opportunity means that income taxes have moved considerably closer to being an effective tax on consumption. 28/ Finally, there is some controversy over whether higher-income persons in fact save a larger share of an increase in income than do moderate- or lower-income persons. 29/

Business saving will also rise as the accelerated depreciation benefits, new leasing provisions, and the expanded investment tax credit work to reduce tax liabilities and raise internal cash flow. Government saving, on the other hand, will decline as a result of the new fiscal policy. Furthermore, to the extent that monetary policy restrains the effects of the fiscal policy shift on economic growth, it will limit the expansion of tax revenues. Thus, while the personal savings rate may be high, the flow of savings may not be enough to finance a large increase in business investment.

Investment. The Tax Act of 1981 will encourage business investment in several ways. First, as mentioned earlier, the cut in marginal income tax rates and the special savings incentives, such as IRAs, may increase the availability of funds for investment. Second the reduction in business taxes--increased

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27/ See footnote 25/. Empirical studies of this issue, however, have the shortcoming that they are based on a protracted period of low rates of return on savings. Prospective returns, on the other hand, are much higher than in recent memory. For many taxpayers, however, the real after-tax interest rate from savings may still be close to zero unless the income from savings is tax-sheltered.

28/ It is of some importance, also, where these extra savings (if any) end up. If the increases in IRAs end up in money market mutual funds, they may serve to fund U.S. government debt and corporate borrowing. If, instead, they find their way into thrift institutions, they are more likely to find their way into investment in housing.

29/ Milton Friedman, A Theory of the Consumption Function (Princeton University Press, 1957), Chapter 9.

depreciation allowances, the liberalized investment tax credit (including the new leasing provision), and provisions for rehabilitation of structures--will reduce the cost of capital and raise cash flow. Third, the boost in final demands from the reduction in personal taxes and increased spending for defense will reduce excess capacity, thereby encouraging further investment. Finally, the tax cuts raise the attractiveness of business investment in equipment and structures relative to investment in owner-occupied housing. <sup>30/</sup> The Tax Act also includes tax benefits for research and development to stimulate technological change. As indicated in Appendix A, however, investment incentives continue to remain sensitive to changes in inflation. Moreover, the tax system retains its bias toward investment in equipment rather than structures. As a result, capital will continue to be allocated somewhat inefficiently among different kinds of assets.

#### Economic Growth and the Conflict Between Monetary and Fiscal Policy

Past experience with tax cuts suggests that the Economic Recovery Tax Act can have a substantial impact on economic growth. In particular, the tax cuts should provide a sizable boost to investment. But this experience tells little about the outcome of the combined policies of tight credit conditions and large tax cuts, coupled with large, persistent deficits. Some economists believe that tight credit conditions will choke off growth over the next several years (see Chapter II).

The recent high interest rates and weak economic growth have raised the cost of capital and left firms with idle plant capacity, and an uncertain outlook for sales in the near term. The coming buildup in defense spending and the growth in consumer spending as a result of the tax cuts may increase capacity utilization in industries not greatly affected by interest costs. The net effect depends upon two important tradeoffs in investment decisions:

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<sup>30/</sup> Many economists believe that the previous tax law encouraged investment in housing at the expense of business investment. See, for example, Frank DeLeeuw and L. Ozanne, "Housing," in Aaron and Pechman, ed., How Taxes Affect Economic Behavior (Brookings, 1981), pp. 283-326.

- o Are output and capacity utilization more or less important than capital cost in the formation of investment decisions?  
and
- o Will interest rates move upward enough to offset the increased depreciation benefits--rendering the after-tax cost of capital largely unchanged?

The issue of capacity utilization versus cost of capital variables in the determination of business fixed investment is primarily an empirical one, but it remains unresolved. In the past, tax changes to encourage investment such as those of 1962 have been followed by periods of strong growth in final demands--making the effect of the changes difficult to isolate. The work of Clark 31/ and Eisner/Chirinko 32/ suggests that the role of the cost of capital in investment may be overstated in most large econometric models. However, in periods when resources are fully employed, a reduction in capital costs should produce a significant reallocation from consumption to investment spending.

In the present circumstances, the increase in interest rates could substantially weaken the beneficial effects of the business tax cuts. Continued high real interest rates are expected because of the Federal Reserve's monetary policy, the prospect of large budget deficits, and the increases in investment incentives from the Tax Act.

The implications of an increase in interest rates for the cost of capital are illustrated in Table 21, for different types of investment. The first column shows the effect of the tax changes by themselves on the rental cost of capital (after the Accelerated Cost Recovery System has been fully phased in). The second column shows the combined effect of the tax change and a one-percentage-point increase in the cost of funds. These calculations suggest

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31/ Peter K. Clark, "Investment in the 1970s: Theory, Performance and Prediction," Brookings Papers on Economic Activity, 1 (1979), pp. 73-113.

32/ Robert Eisner and R.S. Chirinko, "The Effects of Tax Parameters on the Investment Equations in Macroeconomic Econometric Models," Office of Tax Analysis Papers 46 and 47, U.S. Treasury Department (1981).

TABLE 21. THE IMPACT ON THE RENTAL COST OF CAPITAL OF THE ACCELERATED COST RECOVERY SYSTEM (ACRS) AND A RISE IN INTEREST RATES, BY ASSET TYPE (Percentage change)

Asset Category	Effect of ACRS With No Change in Real Interest Rates (Percent)	Effect of ACRS and a One-Percentage Point Increase in Real Interest Rates (Percent)
Cars	-6.1	-2.6
Trucks, Buses, and Trailers	-8.4	-3.7
Construction Equipment	-8.4	-2.3
General Industrial Equipment	-11.4	-4.7
Industrial Steam Equipment	-19.7	-10.9
Utility Power Plants	-8.1	8.1
Industrial Buildings	-8.7	0.0
Commercial Building	-14.0	1.0
Apartment Buildings	-6.8	12.3
Apartment Buildings (Low Income)	-8.2	11.0

NOTE: The illustration assumes a 6 percent inflation rate and that the tax changes have been fully phased in. The tax deductibility of interest costs has been ignored in this calculation.

SOURCE: Jane G. Gravelle, "Effect of the Accelerated Cost Recovery System by Asset Type," Congressional Research Service (August 31, 1981).

that it might not take a very large increase in the cost of funds to undo much of the beneficial effect of the tax measures on business investment. According to a recent Library of Congress study, if the real rate of interest increased by one percentage point, then as much as half of the impact of the tax changes might be lost for cars, and three-quarters for construction equipment (see Table 21). The effect could be substantially greater for structures than for equipment, because of the longer life of structures. The increase in interest rates completely offsets the lower tax effect for industrial buildings and more than offsets it

for apartment buildings. This analysis suggests that monetary policy could effectively short-circuit much of the favorable impact of ACRS on investment.

#### CONCLUSION AND POLICY OPTIONS

The outlook for economic growth over the next few years is uncertain because of three factors. First, a restrictive monetary policy constrains the likely growth in nominal GNP over periods of more than one year. Second, the strong inflation momentum--largely the result of rising unit labor costs--reduces the amount of feasible real growth in GNP in this monetary environment. Nominal wage increases in the past have not shown much sensitivity to economic slack or to changes in macroeconomic policies. Productivity growth--the other main determinant of unit labor costs in addition to nominal wages--seems likely to improve, but only moderately. The third factor is the clash between an expansive fiscal policy and a restrictive monetary policy, which could produce lackluster performance for investment.

It is possible that inflation will subside much more quickly than anticipated in a way that would permit more rapid economic growth. This could happen if nominal wage increases slowed sharply, or if productivity grew rapidly for longer than the usual cyclical upswing. The first of these favorable possibilities is perhaps more likely than the second, given recent developments in collective bargaining. But historical experience suggests that neither is likely.

A shift in economic policy might override the inhibiting factors, though not without difficult tradeoffs. Monetary policy could be eased, but at the cost of further inflation. Alternatively, fiscal policy could be adjusted to provide smaller deficits--an option discussed in the next chapter. Other options, such as incomes policies, are not discussed here because they are not being actively considered by policymakers.



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## CHAPTER V. ECONOMIC EFFECTS OF FEDERAL BUDGET DEFICITS

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If the prospective rise in the federal budget deficit were exclusively, or principally, a temporary cyclical phenomenon, there would be little cause for concern. Indeed, rising budget deficits during periods of recession serve to limit both the magnitude and duration of the decline in economic activity. Once the recovery is underway, the recession-induced bulge in the deficit disappears as tax revenues grow and as outlays for unemployment compensation and other programs decline.

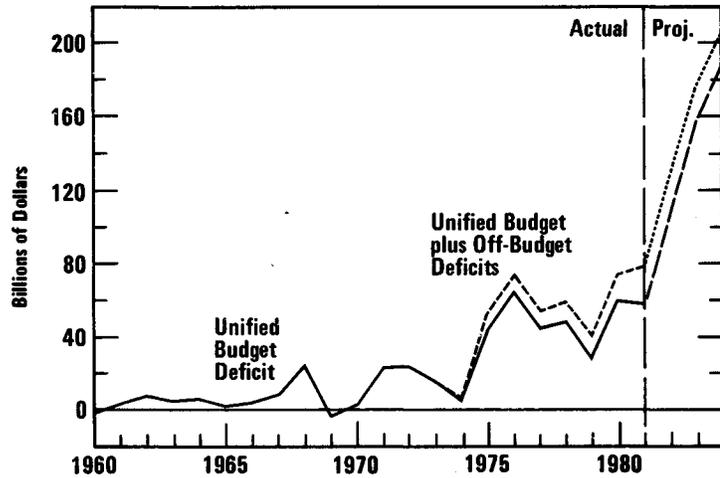
Unfortunately, the budget problem facing the U.S. Congress is neither exclusively nor principally recession-related. It is, rather, a problem of prospective chronic budget deficits. Without significant legislative changes in federal spending and tax laws, the trend appears to be one of large and growing federal budget deficits, not only during the recovery from the current recession but for the foreseeable future as well (see Chapter III).

The problem of chronic budget deficits is not new, as evidenced by the fact that the federal budget has been in surplus only once in the past 20 years (see Figure 16). However, the difficult economic and budget issues raised by these earlier deficits pale by comparison with the problems that face the country today. No clear economic rationale exists for the persistence of deficit spending year after year, and the distinct possibility exists that the very large and rising budget deficits projected in this report could seriously impair the overall performance of the economy. 1/

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1/ In a Keynesian spirit, it can be argued that a government deficit may be needed to hold the economy at a desired level of output if other sectors of the economy save more than they invest. Even in a Keynesian framework, however, an argument for persistent deficits over a prolonged period would require a demonstration that oversaving by the private sector is a chronic or secular condition. See James Tobin, "Deficit, Deficit, Who's Got the Deficit?" National Economic Policy (Yale University Press, 1966) pp. 49-55.

Figure 16.  
Actual and  
Projected Budget  
Deficits



SOURCES:  
U.S. Office of Management and  
Budget for historical data; CBO  
for projections.

It is the purpose of this chapter to examine briefly the issues under debate concerning the effects of federal government deficits. Unfortunately, the available evidence suffers from one severe limitation: the prospective U.S. federal budget deficits, both in magnitude and as a proportion of GNP, considerably exceed peacetime historical experience. Any conclusions based on such evidence must, therefore, be interpreted cautiously and tentatively.

#### ECONOMIC IMPACTS OF BUDGET DEFICITS: THE EVIDENCE

The adverse economic consequences of federal deficits depend to a considerable extent on how budget deficits are financed. They can be financed in two ways: by direct borrowing from the public (including borrowing from abroad), and/or by expanding the money supply.

- o The increased competition for funds induced by federal government borrowing drives up interest rates, crowding out private-sector investment. Ultimately, the reduction in private investment hurts productivity growth and worsens inflation. In the face of chronic budget deficits, these adverse effects are compounded by the further increase in outlays for interest on the federal debt caused by higher interest rates.

- o Increased federal government borrowing exacerbates inflationary pressures if the Federal Reserve is induced to expand the money supply to limit the rise in interest rates. 2/

The relationship between budget deficits and other economic variables is not as clear-cut and simple as these statements imply. For example, simple contemporaneous plots of data for the U.S., as well as for other industrialized countries, show only a weak association between budget deficits on the one hand and interest rates, money supply growth, and inflation on the other. However, as explained below, a major reason for the weak association is that changes in budget deficits can be both passive, reflecting changing economic conditions, and policy induced, reflecting various kinds of budget initiatives.

Deficits and Interest Rates. Since 1960, increases in the federal deficit have often been associated with decreases in interest rates. This reflects the fact that deficits and interest rates are both sensitive to other variables, particularly the level of economic activity. When GNP growth slows, the deficit rises as tax revenue growth falls and government outlays for social insurance rise. At the same time, interest rates fall because of reduced demands for credit from borrowers other than the federal government. 3/ Interest rates are also affected by foreign purchases of U.S. debt quite independently of U.S. budget deficits. Thus, it is not surprising that the simple plot of interest rates and budget deficits in the U.S. does not show a strong association. 4/

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2/ For a statement of these arguments, see the testimony of Budget Director David Stockman before the Senate Budget Committee, September 11, 1981, and Michael Hamburger and Burton Zwick, "Deficits, Money, and Inflation," Journal of Monetary Economics, vol. 7 (1981), pp. 141-50.

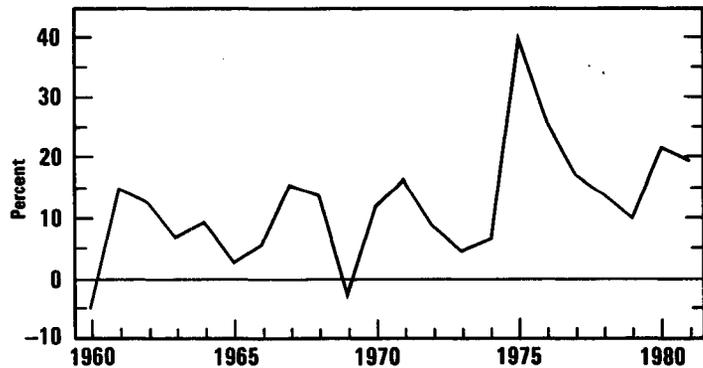
3/ Interest rates do not fall as far as they would if the deficit did not increase at the same time. In this sense, it can be said that the increase in the deficit, taken by itself, increases interest rates.

4/ Experience in other industrialized countries also shows that the association between budget deficits and interest rates is not clear cut.

Figure 17.  
**Direct  
 Federal Borrowing  
 Absorption Rate**

NOTE:  
 1981 data point is the average value  
 for the first 3 quarters of 1981.

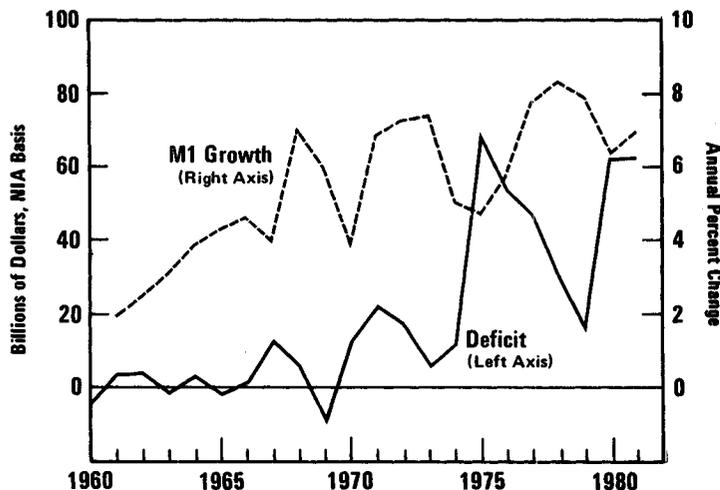
SOURCE: Federal Reserve System,  
 Board of Governors.



Many analysts believe that a more useful indicator of the upward pressure on interest rates induced by federal government borrowing is provided by the so-called "absorption rate". Figure 17 shows direct borrowing by the Treasury as a percentage of total credit raised by U.S. nonfinancial sectors for the past 20 years--a measure known as the "direct borrowing absorption rate".<sup>5/</sup> During recession years, this ratio rises sharply because of reduced private-sector demands for credit and automatic increases in the federal deficit. However, even when the recession years are excluded, the absorption rate shows a modestly rising trend. This secular increase in the absorption rate is believed to have contributed to the recent rising trend in interest rates. In view of prospective sharp trend increases in the absorption rate induced by

<sup>5/</sup> This definition of the absorption rate differs from another often-used definition--the ratio of direct federal borrowing plus borrowing by federally-sponsored private agencies plus federally-guaranteed private borrowing to total credit raised by nonfinancial sectors. The "direct borrowing" absorption rate excludes federally-guaranteed and federally-sponsored borrowing because some of this might have occurred even without federal participation.

Figure 18.  
U.S. Federal Deficits  
and M1 Growth



SOURCES:  
U.S. Department of Commerce,  
Bureau of Economic Analysis;  
Federal Reserve System, Board  
of Governors.

rising budget deficits, the upward pressure on interest rates in the near term, at least, could be substantial. <sup>6/</sup>

Deficits and Money Growth. Another widely-held view is that deficits have put pressure on the Federal Reserve to expand the money supply in order to stem the upward pressure on interest rates caused by increases in the deficit. As shown in Figure 18, increases in the deficit are often associated with periods of

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<sup>6/</sup> Phillip Cagan has argued that deficits themselves may not be entirely responsible for the rise in the absorption rate. This is because a significant fraction of the federal deficit in recent years has been accounted for by outlays for interest on the federal debt. Interest has in turn been high because of the high inflation premiums embodied in recent interest rates. The function of these inflation premiums is to reimburse holders of federal debt instruments for the decline in the real principal value of their assets that is caused by inflation. It is therefore likely that many wealthholders would choose to save these enlarged interest receipts in order to maintain the principal value of their investments. Cagan's explanation for the high recent levels of the absorption rate is that bondholders may have chosen to invest their interest receipts in real goods like jewelry and artwork rather than in

weak or negative money growth. This happens for cyclical reasons much like those discussed above: money growth slows when economic growth is weak because less money is demanded to carry out transactions. 7/

However, this historical experience may not furnish a guide to how deficits and the money supply will interact in the United States during the next few years. The behavior of the money supply is determined above all by the actions of the Federal Reserve System, which has put heavy emphasis on reducing money growth rather than controlling interest rates in recent years. Since it adopted this policy, interest rates have been more volatile and, at times, higher than ever before. This suggests that the Federal Reserve may now be willing to allow interest rates to rise to a much greater extent than in the past. Nevertheless, many analysts believe that the Federal Reserve will decide to ease its policy if prospective federal deficits are anywhere near as large as those in the CBO baseline projections. This subject is discussed further in Appendix B.

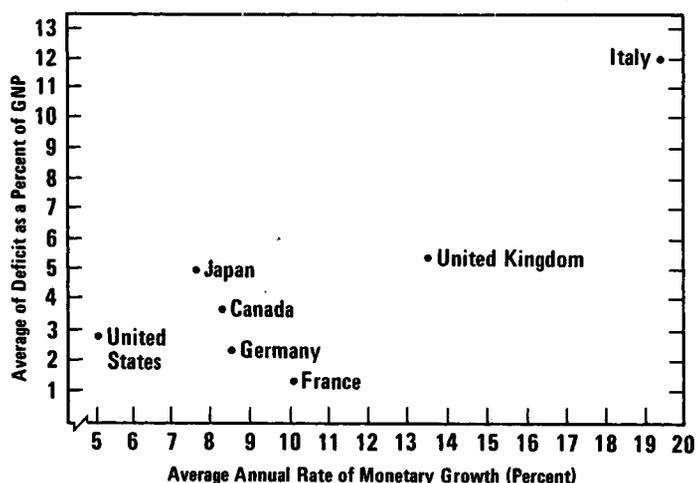
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6/ (Continued)

financial assets. The absorption rate is therefore higher than it would otherwise be because the flow of financial saving is smaller. The main reason that investors may have chosen real rather than financial assets, Cagan argues, is the high inflation rate, which reduces the real after-tax rate of return on financial investments relative to that on real goods. See Phillip Cagan, "The Real Federal Deficit and Financial Markets," in The AEI Economist (November 1981), pp. 1-6. Cagan's arguments do not contradict the adverse consequences for investment and productivity caused by high absorption rates.

7/ Evidence from a group of seven industrialized countries for the late 1970s is also mixed when budget deficits are compared in a simple way to rates of money growth. As Figure 19 shows, there appears to be some correlation when the group of seven countries is considered together. If attention is restricted to Japan, Canada, West Germany, and France, however, the conclusion that higher deficit ratios are associated with higher rates of monetary growth is reversed.

Figure 19.  
 Comparison of Central  
 Government Deficits  
 and Monetary Growth,  
 1975-1980



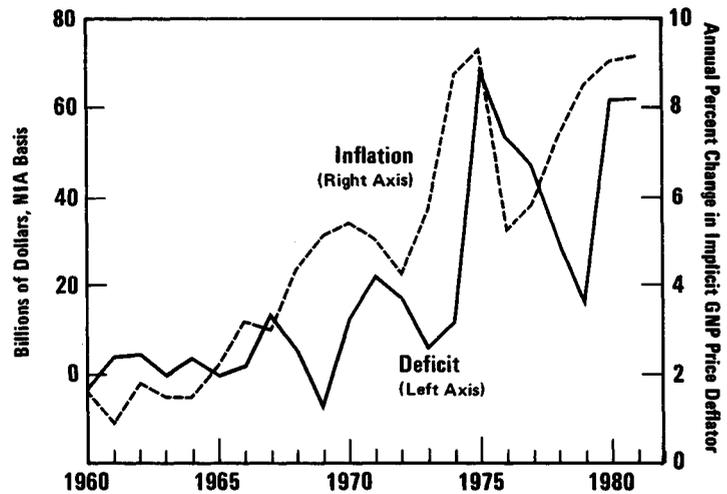
SOURCE:  
 International Monetary Fund.

Deficits and Inflation. Do increases in the federal deficit necessarily lead to increases in inflation? As Figure 20 shows, there appears to be some correlation between the two variables in recent U.S. experience. Generally, however, increases in inflation have preceded increases in the deficit. This may occur if rising inflation causes the economy to weaken (and the deficit therefore to increase) through commodity shocks or because the Federal Reserve is induced by increases in inflation to tighten monetary policy. In any case, it is hard to conclude from contemporaneous changes in these two variables that increases in the deficit predictably cause increases in inflation. <sup>8/</sup> One reason is that policy-induced deficits may affect economic activity with a lag.

<sup>8/</sup> Evidence from a group of seven industrialized countries on the relationship of the deficit to the inflation rate is, once again, mixed. As Figure 21 shows, there does appear to be a correlation between the average annual deficit as a percentage of GNP and average annual rates of inflation during the late 1970s. The relationship is weakened, however, by the cases of Japan and France as well as by Italy, which had about the same average inflation rate as did the United Kingdom despite a deficit ratio more than twice as large.

Figure 20.  
U.S. Federal Deficits  
and Inflation

SOURCE:  
U.S. Department of Commerce,  
Bureau of Economic Analysis.

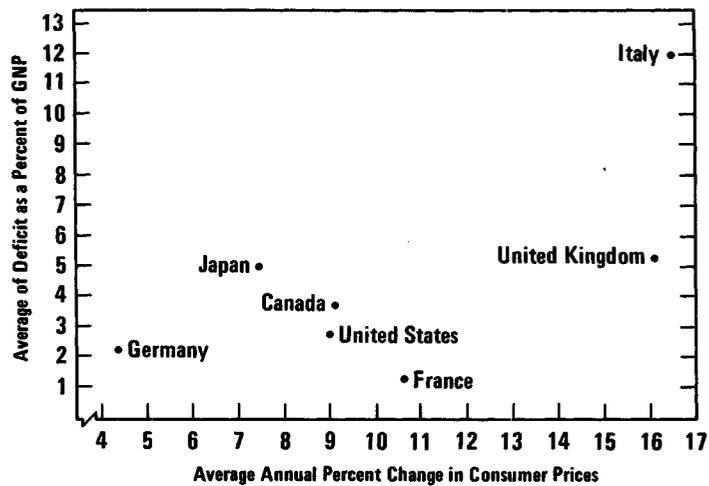


Many large econometric models show such lagged effects when budget policies result in excess demand, as in the Vietnam War period. Policy-induced deficits may also raise inflationary expectations, if the increased deficits are expected to result in easier monetary policy.

#### IMPACTS OF DEFICITS ON INVESTMENT, PRODUCTIVITY, AND INFLATION

Few generalizations can be drawn from simple two-variable analyses of the short-run effects of budget deficits. The relationship of budget deficits to other economic magnitudes is quite complex. Certainly one cannot conclude that a temporary rise in deficits inevitably causes high interest rates, rapid inflation, or fast monetary growth. In the short run, the impact depends upon the source of the deficit and the state of the economy. But if large and rising deficits are allowed to persist over the longer run, despite the economy's level of operation, then their effects on interest rates and investment may lead to severe economic problems. Policy-induced increases in the deficit that crowd out private investment have serious consequences over the long run for productivity growth and inflation. There is evidence, too, that policy-induced deficit increases may cause the money supply to increase, though this evidence seems weak, especially in recent years.

Figure 21.  
 Comparison of Central  
 Government Deficits  
 and Consumer Price  
 Inflation, 1975-1980



SOURCE:  
 International Monetary Fund.

### Investment Impacts

Although there are strong reasons to believe that policy-induced deficits reduce private-sector investment by bidding up interest rates, 7/ there may be mitigating factors under certain

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7/ A second way in which investment may be crowded out by policy-induced deficits is more direct: if the deficit arises because of government spending for public-sector investments that are close substitutes for private-sector investment (for example, manpower-related spending), private firms may scale back plans for similar expenditures. The productivity implications of this "direct crowding out" are complex. Some economists have argued that little productivity impact need be felt; see Paul David and John L. Scadding, "Private Savings: Ultrarationality, Aggregation and 'Denison's Law'," Journal of Political Economy (March/April 1974), pp. 225-49. More

conditions. As the discussion below will show, policy-induced deficits may even increase investment if the economy is weak or if the deficit arises from efforts to increase investment incentives. New flows of saving may arise in response to policy-induced deficits that stimulate aggregate income growth or attract funds into the economy from abroad. Moreover, even if private investment is reduced by increases in the deficit, the consequences for productivity growth may be mitigated, as some observers have argued, if some of the funds diverted to the federal government are channeled into public-sector investments that themselves increase productivity growth. Finally, policy-induced increases in the deficit may be offset by growing state and local government surpluses: what matters ultimately is the change in total government borrowing, not just federal government borrowing.

Two of the major determinants of business investment are: (1) the cost of external funds and (2) the utilization of existing productive capacity as well as expected capacity utilization in the future. Policy-induced deficits influence both of these determinants, but with opposite effects on investment. To the extent that such deficits raise real interest rates, investment spending will be lower than otherwise. But to the extent that deficits raise aggregate demand, raising both existing and expected capacity utilization rates, investment spending will be higher than

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7/ (Continued)

recently, however, George von Furstenberg has argued that productivity may still suffer because of reductions in private saving that may be caused if government investment is debt-financed. See George von Furstenberg, "Public versus Private Spending: The Long-Term Consequences of Direct Crowding Out," in George von Furstenberg, ed., The Government and Capital Formation, pp. 243-63.