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TEMI DI DISCUSSIONE

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Two pieces on current policy issues:
— Appraising the American Fiscal Stance
— Uncertainties over the Economic Recovery of the United States

APPRAISING THE AMERICAN FISCAL STANCE

by

Edmund S. Phelps

The 1980's have seen a massive decrease in world saving, and thus in aggregate world investment. Behind that fact is a variegated pattern: there has been a huge structural decrease in public saving, especially in the United States -- an important case because of its large scale -- and also, on a smaller scale, in Italy and a few countries in Scandinavia. Most of the deficits elsewhere are cyclical, not structural. (But whether structural or cyclical there has resulted a huge increase in public debt.) Further, there has been no offsetting increase of private saving, despite a rise of the world real interest rate. There has been a cyclical fall of private saving.

What are the consequences of this pattern? What are the benefits and costs for America? For Europe and the others? Ought Europe to imitate America's fiscal policy? These are the questions confronting us. Here I can only throw out some ideas, and express the hope and expectation that many other insights will emerge from the regular papers that lie in store for us at this conference.

APPRAISING THE AMERICAN FISCAL STANCE (*)

I

For America there have been real benefits, and costs of course, from the deficit spending and also from the tax incentives generously offered for investment by American firms. For America there has probably been a balance of benefits over costs. To endorse that conclusion is not to endorse the theories of the supply side economists, since <u>our</u> reasons for reaching that conclusion might not be <u>their</u> reasons and <u>our</u> policy prescriptions might differ significantly from <u>theirs</u>. <u>1</u>/ (Nor it is implied that their reasons were Reagan's motives.)

The evaluation of the American fiscal stance must recognize the unusual setting in which the tax cuts have developed. There has been a forceful and unremitting attack on inflation by the monetary authorities since late 1980. The tax cut installments were decided upon in 1981 and later revised or endorsed in 1982 and 1983, years when the tight-money policy was exerting a strong contractionary effect on employment and upon investment.

1. One benefit from the fiscal shift is that it seems to have caused a real appreciation of the dollar and a consequent "setback" in the ascent of the price level. Insofar as this pause of the price level then slowed workers wage demands, there has resulted a "permanent" slowing of the wage trend and price trend. Thus less monetary tightening and less unemployment has been required for the disinflation achieved than would otherwise have been needed.

It might be objected that these price-level and inflation reductions are only as permanent as the extraordinary budgetary deficit, and once the deficit is ended the path of the price index and the trend inflation rate will rebound to their former levels. The benefit from the deficit is thus borrowed against the future, not earned. It may well be that the inflation improvement is more fundamental, however. To support this claim I would appeal to the incomplete spread of indexation of wages to prices. The unexpected slow-down, or deceleration, of the price trend causes an unexpected slow-down of the already-negotiated indexed wages; so the unindexed wages when renegotiated will be cut to regain their unexpected loss of competitivess. Thus there is a second round of deceleration of prices and wages. This after-effect is important because it permits the fiscal stance to return to normal without completely undoing its accomplishment! 2/ However, it may well be that most of the appreciation of the dollar cannot be credited to the general cut of taxes, which accounts for most of the public dissaving; perhaps most of the appreciation was due to the upward pull on American real interest rates from the 1981 investment tax incentives. 3/ The 200 billion dollar deficit is not cost-effective in this view.

Replying to the objection that the benefit is borrowed from the future, defenders of the fiscal stimulus can also argue that there is a gain provided the stimulus is phased out gradually so as to "smooth" the costs of the disinflation.

2. Another likely benefit to the United States from the American tax cut involves the supply of labor. Indeed the effect of tax reduction on labor supply was the

mainspring in the founding supply siders' original theory as told to Winniski (1981). We are to suppose that higher pay provides an incentive to work more -- that an increase of after-tax wage rates brought by an income tax cut elicits a corresponding increase in the amount of labor supplied; this is the way the world works. Consequently a tax cut will slow down wage rates by boosting the level of unemployment from the supply side of the labor market. (A colossal tax cut might even force a fall of wages, requiring easier money and increased employment, not tighter money, to stabilize prices.) Anyone can see that it would be better to recruit volunteers to wage the war against (wage) inflation than to conscript job holders on some seniority or other discriminatory basis; this way, the voluntary way, the combatants against inflation are self-selecting. But the premise is troubling: what if the supply of labor is, at least locally, quite inelastic with respect to after-tax wage rates or even backward-bending? A supply-side answer is that in the Republican world of dynastic families, secure in their ancestral homesteads and butressed by their faith, there is no income effect from a tax cut which would (taken alone) make people work less: people know they or their heirs must pay their share of the government sooner or later, one way or another. A more plausible answer, in any case, is that the tax cut will be seen as temporary (which, in large part, it probably is), so that people have every reason to take advantage of the <u>relative</u> improvement of current rewards, working more now and less later. (It is also true that better after-tax rewards for above-ground jobs will draw people out of underground work, and that will increase the total supply of output.)

3. A third benefit from the tax cut relates to a famous problem concerning inflation and disinflation. In his 1939 study of the German hyperinflation Brescani-Turoni noted that inflation raises nominal interest rates and reduces real cash balances, while ending the inflation does the reverse. If the Federal Reserve abruptly halted the growth in the supply of money, in order to signal its disinflationary desires, the ensuing drop of nominal interest rates entailed by reduced inflation expectations would (if actually realized immediately) cause a jump in the amount of money demanded -- a rush from goods back into money -- and thus force a contraction of income and employment until supply and demand were again equal. A general tax cut (necessarily a temporary one in an essentially stationary economy) meets this problem in two ways. By reducing the tax rate on interest income it helps to hold up the after-tax interest rate of which the demand for money is a function. By creating expectations of "crowding out", and thus a one-time rise of the price level as a result, it moderates and cushions the fall of before-tax interest rates that would otherwise be entailed by money-supply stabilization. And tax cuts that raise the real interest rates that businesses can pay likewise serve to cushion before-tax nominal interest rates. 4/ Of course, the tax cut had better be "phased out" gradually, not abruptly if the problem of a sudden drop of interest rates is to be surmounted, not merely deferred.

4. A fourth benefit is little discussed. Since the disinflation exercise of the Federal Reserve entailed a big slump in employment and income it is appropriate that the generation suffering this misfortune receive some compensation in the form of deficit-financed tax relief and

transfer payments even if that move will come at the expense of future generations. The argument here is similar to that in favor of deficit financing of the public outlays to conduct a war, which goes back at least to Ricardo. I believe the argument is valid under the intergenerational welfare criterion called utilitarian -- the Ramsey sum-of-utilities criterion -- as well as under the Rawlsian "maximin" criterion, which in this context calls for equal sharing among the generations. Of course this is not an argument for an indefinite, undiminishing deficit. 5/

5. I would not like to leave this topic without making a point that relates to the 1981 investment tax incentives rather than to tax cuts <u>strictu sensu</u>. I never expected I would have a good word for them, but I find now I do. These tax incentives may have played an important role in dampening the recession, or dip, in the capital stock that would otherwise have resulted from the central bank exercise in disinflation. The desirability of that seems an obvious truth: who can be against stabilization of anything, especially the sacred capital stock! Then it seems like an obvious error: doesn't the marketplace (even if only in America) determine the right volume of investment, assuring that the marginal product of capital stays equal to the world cost of capital (or world real interest rate)? But that optimistic view overlooks the side effect of the capital stock on employment in a sticky money-wage or even sticky real-wage open economy: the unemployment first created by the impact of disinflationary monetary policy is magnified by the erosion of the capital stock it precipitates. It was beneficial for the United States to check this decline with tax inducements.

I have identified five benefits to the United States from the loose fiscal stance taken in the early 1980's. Alongside these national benefits stand two national costs. One arises from the loss of national wealth, and hence of "potential" national income, resulting from the budgetary deficits -- especially the personal income tax cuts, less so the fiscal investment stimulants (which operated to back added foreign indebtedness with added domestic capital). 6/ The other national cost is less easily measured. It is the worth, or shadow-cost, of the customers lost to American firms in overseas markets resulting from the fiscal stimulus and the associated appreciation of the dollar. 7/ I have suggested that the national benefits outweighed the national costs in the early 1980s. But costs intensify and benefits erode, so a gradual phasing out of the fiscal stance is indicated.

II

One of the most difficult questions about the American deficit is its effects on the rest of the world. One would guess, at first blush, that the effect of the deficit and particularly of the investment tax incentives on the real rate of interest calculated in terms of the representative basket of goods produced in America has been a great blow to the debtor nations, Mexico, Brazil, Argentina and the rest. In the rosiest scenario this blow will force them to produce with industry and efficiency as never before, almost as if a war had cost them much of their wealth. (Recall the effects on Britain of the loss of its overseas income after the second world war: two decades of saving and hard work until the Beatles.) In the bleakest scenario this blow will destabilize their governments. There is also the resulting appreciation of the dollar, which harms the debtor nations to the extent their debts are fixed in dollars and to the extent that the real prices (in terms of Latin exports) of the American exports that the debtors import -- in short, America's terms of trade -- have been driven up as a result. I confess I do not appreciate the calculation that says the real depreciation of pesos and cruzeiros makes it easier for the debtor countries to export, though I can understand that the contribution of the American deficit to American employment and income is a "plus" for Latin America. 8/ However we come out on these effects, it is beginning to seem rather uncertain that the real interest bill of the debtor nations will be genuinely paid, as distinct from being capitalized, which means borrowing always to "pay" the interest. The major price paid by the debtor countries may turn out to be the political problems and diversion caused.

For Europe the effects are more problematic. It can be argued that the real appreciation of the dollar resulting from the American fiscal actions, hence the real depreciation in Europe, has raised the wage demands of European labor in terms of European goods -- the real wage rigidity hypothesis. Then there is the dollar-price-of-oil rigidity hypothesis, however plausible or implausible it may be. But why should a deficit-caused real appreciation of the dollar be associated with a rise in the real prices, as measured in European goods, of imported goods (final or intermediate) consumed by European workers? A real appreciation of the dollar does not necessarily raise the real price of American exports of consumer goods or other goods. Such a rise could have resulted to the extent that the tax cuts crowded out American exports of some goods --

wheat? aircraft? computers? -- and in so doing raised appreciably their market-clearing prices. Such a rise could also have resulted to the extent that American exporters operate in customer markets and (like a Phelps-Winter firm) refuse at first to obey the "law of one price". It seems likely, however, that the real appreciation of the dollar is in large part a failure of the prices of nontradeable construction and services to fall pari passu with the cost of foreign exchange, and to that extent it cannot precipitate new wage demands in Europe.

Another effect works to stimulate European employment. It can be argued that the real interest rate rise caused by the investment tax incentives spells higher nominal interest rates in Europe, given the paths of the European money supplies, and this must cause dishoarding, a rise of the price level and a nominal (even if not real) depreciation in Europe; producers will respond with increased output for export abroad, in part to American firms importing machinery at a faster rate. True, this European "boom" will be temporary, but natural rate doctrine says that every fluctuation of employment is temporary. More accurately, the effect will only be to speed up recovery in Europe from the slump caused by the monetary disinflation in the United States, a recovery that would have taken place anyway according to natural rate theory; of course the "speeding up" dwindles as nominal wages adjust.

Perhaps the most serious indictment of the American fiscal stance is that it has artificially diverted capital investment to America (where there would have been none absent the incentives) from Europe and elsewhere in the rest of the world. By what rights did the United States do that? Had the American government established a huge subsidy for purchases of painting or for world-class performances of grand opera, the rest of the world would have risen up in indignation at the "unfair" reallocation of resources. There is a "beggar-thy-neighbor" aspect to the American fiscal maneuver.

III

What is sauce for the goose is sauce for the gander. In its quest to extricate itself from its long slump would there not be large benefits to Europe if it chose to adopt the American fiscal stance? Moreover, turnabout is fair play. So wouldn't it be just to do so?

Before beginning we ought to note that the European countries are not scale replicas of America, in structure and situation, so we should not expect cost-benefit comparisons to yield exactly the American results. A European country that adopted the American fiscal stance could find a lesser appreciation or even no appreciation of its currency, since investors might attempt a flight from the country's assets in anticipation of the risks of subsequent extraordinary taxation or other terrors. A European country that is not facing inflation would derive less benefit from supply-side measures.

Let us confine our analysis to one choice: either Europe will adopt the "loose" fiscal stance and America will be encouraged to maintain the same stance, with both phasing it out over several years, or Europe rejects this policy and America proceeds to phase out its present fiscal stance over a brief period of transition.

If all or most countries were to adopt the American fiscal stance, and likewise use monetary policy to keep a tight rein on the money supply or perhaps the money wage level, the fall of national wealth in the "average" country would be approximately matched by a fall of domestic capital. Further, the decline in the capital stock located in a country would lower its wage income and thus induce a further fall of its national wealth. So there is a kind of multiplier process. We do not know how much crowding out of world capital a given (temporary) world deficit can do.

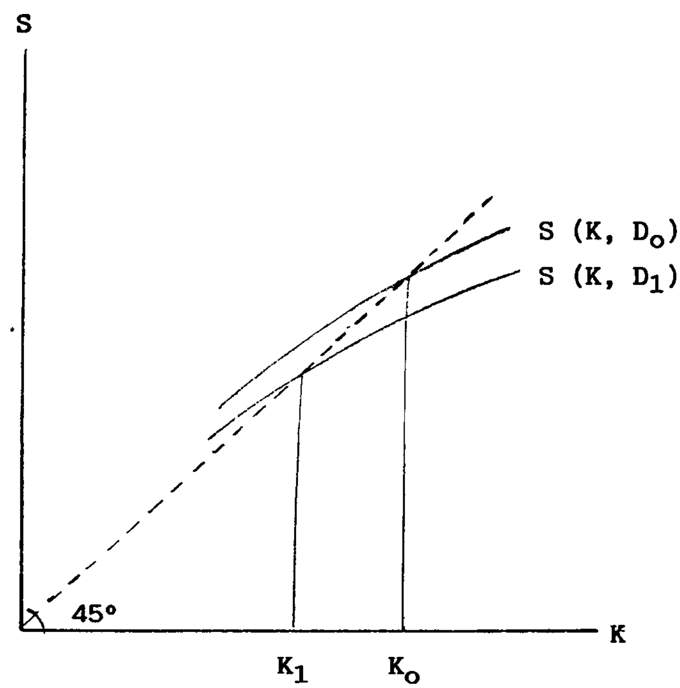

Figure 1

The simple analytics of this process are captured by Figure 1. The diagram there refers to the representative country and shows how its stationary-state desired national wealth -- the number of capital shares it owns at home and abroad, denoted by S -- is a function of the amount of domestic capital, K, that the international capital has allocated to it. A temporary deficit, by stimulating a higher level of consumption at any level of domestic capital and initial level of national wealth, causes national wealth to sink toward a lower steady-state level corresponding to the given K; the S curve shifts down. But the representative country's K must equal its S, since it is neither a net creditor nor debtor. So there must follow a movement down the S curve, possibly converging to the new intersection point as shown. (The diagram reveals a further possibility. The fall of wealth and capital may fail to be convergent.)

One conclusion, then, is that the adoption by all of the American fiscal stance might lead the world much farther down the road to reduced capital. It is better from this perspective that America gradually phase out its deficit than that Europe respond in kind.

Yet this conclusion is unsatisfactory. If the foregoing analysis (section II) is right, phasing out the present fiscal stance in America does not promise a lessening of the unemployment in Europe. On the one hand, the resulting worldwide fall of nominal interest rates would worsen European unemployment. On the other hand, the real appreciation and capital-investment reflux in Europe would tend to shrink European unemployment. So there arises the nagging question of what Europe can do to pull itself out of its long slump. If an exogenous jump of the money supply or a devaluation is excluded as inconsistent with price-level objectives, and if general tax cuts or expenditure increases are not cost-effective, what recourse is left? Are we driven back to a tax cut as the lesser of two evils? A way out of this dilemma, it seems, is a fiscal policy designed to reduce the cost of production for firms. If beggar-my-neighbor investment subsidies (not to mention higher tariffs and export subsidies) are resisted, that leaves employment subsidies paid to firms. By reducing the supply-price of consumer goods, employment subsidies for the hire of low-wage labor would tend to increase real cash balances and thus to permit higher employment with no higher (and perhaps lower) price level. Whatever the particulars, it seems important to get away from conceiving of optimum fiscal policy as the choice of the tax revenue level and thus of the budget deficit. Choosing the structure of tax rates and subsidies is another dimension, and perhaps a more important dimension, of fiscal policy.

N O T E S

(*) Opening address at the University of Sassari conference Private Saving and Public Debt, Alghero, Italy, September 9-13, 1985. The author is McVickar Professor of Political Economy at Columbia University and was Visiting Scholar at Banca d'Italia in the summer of 1985.

1/ The doctrine was first advanced, though without supporting analysis, in Mundell (1971). There have been subsequent analyses in Rodriguez (1978), Phelps (1982), Hoel (1983) and Sachs (1985).

2/ The structure of the argument is the ingenious invention of Jeffrey Sachs (1985), although Sachs's own model makes unindexed wages depend upon price expectations, not wage expectations as here.

3/ In Phelps (1985) it is argued that only the investment incentives legislated in 1981 can explain the world-wide rise of real interest rates.

4/ Rodriguez (1978) proves that the reverse assignment, in which fiscal policy is assigned to price-level stabilization, does not permit monetary policy to stabilize unemployment.

5/ The paper by John Flemming for this conference suggests a variation on this theme. The optimum tax rate decreases when the central bank has to wage "war" against inflation.

6/ In this connection it is often said that the stimulative effect upon domestic employment of budget deficits weakens as they transfer a mounting level of national wealth to foreign hands. There may be an element of old-fashioned textbook truth there, provided the enriched foreigners are less disposed to buy the "domestic goods" than the impoverished nationals. But the weakness or absence of demand-side effects from fiscal stimulus are not generally relevant from the supply-side, or optimum-mix, perspective, since monetary policy can add to them.

7/ See Phelps (1984) for a macro model of this phenomenon.

8/ The same taxonomy has been reached independently by Dornbusch (1985) with the exception of my last point, which is that Latins selling in American customer markets benefit from increased demand since their prices are not competed down to marginal cost.

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UNCERTAINTIES OVER THE ECONOMIC RECOVERY OF THE UNITED STATES

by

Edmund S. Phelps

Within the past dozen years the American economy has suffered shocks unequalled since World War II: the supply shocks of 1974 and 1979 and the disinflation venture, begun in 1981, in which the Federal Reserve embarked upon a sharply tighter monetary policy (measured, say, by some velocity-adjusted money supply) to the accompaniment of a fiscal policy of investment incentives and increased deficits. During this period unemployment set two postwar records, and remains well above the level commonly considered normal. Now, following all this confusing crossfire, the outlook for the American economy is more than usually uncertain.

I shall discuss here the question that is, for me, the most worrisome. Are we safe in thinking that the marketplace provides an automatic mechanism for recovery from monetary disturbances so that, barring fresh shocks, we may expect the average rate of recovery to the economy's normal state of health? Or are there grounds for thinking that full (as well as overfull) recoveries do not occur without the eventual boost of a 'positive' shock or a dose of monetary or fiscal 'activism'?

UNCERTAINTIES OVER THE ECONOMIC RECOVERY OF THE UNITED STATES (*)

I

How certain, barring fresh shocks, is a recovery of the unemployment rate to the level it would be at had these shocks never occurred? In the latter half of the 1960s it came to be believed that, given people's expectations about inflation, there is a rate of unemployment that is normal in that climate; and, moreover, that the economy, once knocked away from it, exhibits a strong homing tendency to return to the normal rate in some gradual, "error correcting" fashion. The level to which the unemployment rate tends is thus invariant to its past history. The only steady-state equilibrium, by implication, was at this normal unemployment rate. In addition it came to be believed at the same time that the normal, or steady-state equilibrium, rate was invariant within limits to the expected rate of inflation -- that the normal unemployment rate is the same, the same natural rate in every expectational climate. But this accelerationist hypothesis is not germane to my question here: will the unemployment rate recover to the level that is normal to, say, 4 per cent inflation? Or is there no such thing as a normal unemployment rate?

A friend from Uganda observes that Americans are born optimists, always thinking that things will work out not too badly no matter that our policies are presumably not the best. Tocqueville noted the same propensity in Americans more than a century ago. Perhaps the brave new doctrine of normal employment owes something to that optimism. Time series analysis of postwar United States employment behavior does not refute the hypothesis of recovery to the normal (and, in booms, regression to the normal); but neither is there strong support for it. Moreover, the hypothesis was never an axiom that economic theorists felt constrained to require of models; it was more a result, an implication, of the first few theories that came into our heads.

The slender evidence for a homing tendency to the normal comes from the Great Depression and earlier major slumps: in time the American economy did achieve a full or <u>near</u>-full recovery without remedial government action sufficiently strong to claim the credit (or to deserve it at any rate). But <u>when</u> if ever would a <u>full</u> recovery from the Great Depression have occurred had World War II not come along to assist? Would the economy have snapped back in 1972 from the Game Plan of Nixon and Burns without the reversal of the monetary engine that year? For that matter, would 1983 and 1984 have been as impressive without the impetus of the investment incentives and other fiscal stimuli which were then taking hold? The American evidence suggests a revised hypothesis: that recovery proceeds only to the broad territory of the normal, and once in this zone its force is inadequate to progress beyond that border; only an upside disturbance or active policy push can drive the economy into the interior of the normal range.

II

In Europe we find evidence seeming to support this revised hypothesis or some more extreme hypothesis. In the 1980s, year after year, the unemployment situation has failed to improve; it changes only for the worse. Here the revised hypothesis seems not to go far enough: In Europe the market creates no tendency toward recovery at all. What is the explanation? New theory is required.

In the typical European economy, I would speculate (if it were my assignment), governments or trade unions have found it popular to index wages -- money wages, or nominal wages -- to the consumer price level (called the CPI in America). To be more explicit I should say I am talking about the practice of indexationism -- the doctrine that money wages ought never to be reduced relative to the consumer price level. Furthermore, governments see it as expedient to replace the income lost by those losing their jobs -- nearly 100 per cent of it if not all of it -- with unemployment compensation and increased eligibility for needs-based welfare benefits. It follows, when these novelties are introduced into otherwise standard monetary-macro models of output and employment, that a slump in the capital-goods-producing sector will do nothing to reduce the demand for consumer goods and thus nothing to lower the consumer price level. (Indeed, if the slump stems from a disturbance that depreciates the currency, the price of imported consumer goods may rise. The sole factor that <u>could</u> serve to lower the consumer price level is the possibility that the "asking" rentals on capital goods in the consumer-good industry are reduced by the same disturbance as capital emigrates from the slumping capital-goods sector. I shall ignore these complicating factors here.) If the consumer price index does not fall, however, and if wage practice allows a reduction or slow-down of money wage rates only upon evidence of a reduction or slowdown of the consumer price level, then wage rates will not be reduced or slowed down. The centerpiece of the automatic adjustment mechanism leading the economy back to the normal unemployment, in the conception of former theory, is completely short-circuited -- short-circuited by the philosophies of indexationism and the Welfare State. (The irony is that no permanent reduction of real wages is required for return to normal employment, only a momentary concession.)

In this model of Europe, let me add, fiscal stimulus in the form of investment incentives or even just increased government spending in the capital goods sector (e.g., military goods) will boost employment as long as these measures can be afforded. At the same time, a fiscal policy of tax cuts and transfers to boost consumer spending impedes or blocks the wage adjustment process that is the market's route to recovery.

III

Does this model of Europe now apply to the United States? To the contrary, the automatic adjustment mechanism that was short-circuited in Europe was able to function in America -- up to a point. American consumer-goods prices did slow down markedly in the early part of the slump. The automatic adjustment mechanism referred to above was thus started up. Indexed wages slowed, causing prices to slow more, and so forth. 1/ It seems that when the displacement or remaining displacement of the economy from the normal is large enough, prices and wages are found responding in such a way that the recovery proceeds: concessions to the situation are acceptable. But it may be, as implied by the revised hypothesis above, that once the remaining displacement is small, firms feel no longer free to slow down wages in response to a further slowing of the consumer price level; or they feel no longer impelled to reflect the latest slowing of wages in the prices they set. If so, it may be that America now requires an activist policy of fiscal stimulus (or, more problematically, monetary stimulus) to eliminate the remaining displacement in order to return to the average level of unemployment.

It could be argued, however, that the model of Europe will apply to America with a lag: that consumer prices slowed only because of the appreciation of the dollar that developed out of the investment tax incentives enacted in 1981, and when these incentives are dismantled consumer prices will rise sharply. Thus the adjustment mechanism will be thrown into reverse. In this event too there is room for a suitably targeted fiscal stimulus.

My feeling about the American situation, then, is that the present level of fiscal stimulus, although not as potent in my opinion as some economists regard it, is needed to maintain the present degree of recovery -- at least it may be needed until slow-operating forces work their way. The investment incentives served as a disinflationary partner that to a degree offset and substituted for monetary disinflation. Abrupt withdrawal of this stimulus would weaken the dollar and lower interest rates while it reduces output and employment. In view of the former effects, there would be little popular support for substantially easier money -- for a major boost of the money supply. Such a boost would be seen as lowering interest rates that were already low and further weakening the dollar, thus raising the price level. Without an increase of the money supply, some of the recovery thus far achieved would be reversed. The situation, then, gives ground for worry.

N O T E S

(*) This report was read at the meeting of the Tocqueville Society in Paris on June 13, 1985. The author is McVickar Professor of Political Economy at Columbia University and was Visiting Scholar at Banca d'Italia in the summer of 1985.

1/ This is not the only adjustment mechanism at work, or so I would argue.

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