



PUBLIC FINANCE

Professor Richard A. Musgrave

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Reviewed by Col R. W. Bergamy, USAF on 26 September 1963

INDUSTRIAL COLLEGE OF THE ARMED FORCES
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11 September 1963

CONTENTS

	<u>Page</u>
INTRODUCTION--Colonel Bradish J. Smith, USA, Member of the Faculty, ICAF.....	1
SPEAKER--Professor Richard A. Musgrave, Professor of Economics and Public Affairs, Princeton University.....	1
GENERAL DISCUSSION.....	20

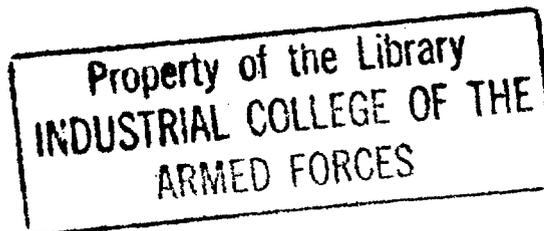
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Reviewed by: Col. R. W. BERGMAYER, USAF Date: 26 SEPT 1963
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INDUSTRIAL COLLEGE OF THE ARMED FORCES

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COLONEL SMITH: Gentlemen: We are most fortunate this morning to be able to hear from a top-flight economist who also has had a great deal of practical experience outside of the cloistered academic halls.

I think you can see from his biography that our speaker knows a great deal about the fiscal and economic affairs of ^{A LARGE} ~~this~~ part of the world.

It is my privilege to present the Professor of Economics and Public Affairs ^{At} Princeton University, Dr. Richard A. Musgrave.

DR. MUSGRAVE: Colonel Smith, Gentlemen: I am very happy to be here, and only hope that in this hour I will be able to tell you something about the fiscal problems which will be of use to you. Of course it is a little difficult for me, not knowing exactly how much work you have been doing in this area and sort of where I come in, but I hope that in the discussion period which is to follow we will be able to make up for this.

In the meantime I think what I would like to try to do is to give you sort of a general survey picture of what is the role of the public sector, if I may call it that, in our economy, and what are some of the main problems which result from operating it.

There is one thing fortunate about speaking to this audience, of course, and that is that sort of by definition I don't have to apologize for the existence of the public sector, for obvious reasons. And I think this will make matters simpler.

Now, let me begin right at the outset on this blackboard here, and try to put some of the more important figures before you. I will also in the process of doing this refer to this little Economic Indicators here which I understand you have and which gives most of the data which I am going to use, although not entirely all of them. What I am doing really is to draw on some of the figures which are given on page 1 in the Economic Indicators, where you see that the economy is divided into four sectors--the personal sector, the business sector, the international sector, and the government sector. For each of the sectors you see what they get as income, what they spend, and to what extent income exceeds expenditures or to what extent expenditures exceed income.

Then, by the simple trick of the accounting system involved, you will find on this page 1 that the excess of expenditures over receipts by any one group must be matched by an excess of receipts over expenditures by the other group. This is simply in the nature of the national accounts/^{that} for any past period total receipts are equal to total expenditures.

We are now just really looking at the government part of this, but I am going to go into a bit more detail, breaking it down by the federal level as against the state and local level. I do think that it is wrong to think of the public sector as being just a federal affair. I think that is true insofar as national security is concerned, because by its very nature this has to be federal and in turn it entirely now dominates the federal budget picture.

But if you come to public services other than national security, then the state and local level, of course, is very important. Historically, traditionally, the state and local level has been much more important than the federal level. It is only since the thirties that the federal level increased in importance in

this field. But I think if you take a longer perspective, apart from the national defense, the state and local share will probably increase in importance. So I think we do want to have it in the picture.

So let me put down here the Federal Government and here the state and local. Normally, ⁱⁿ all of these statistics the state and local are combined into one and we don't have to break it down. Then we get roughly the following picture. Let me begin here with expenditures. Let me divide expenditures into two types. One of these is purchases and the other is transfers. This is obviously an important division, because, to the extent that the Government buys goods and services, it is as it were the ultimate determinant of what is being produced, because producers will produce what the market wants to buy, and in this case the Government is in the market. So, if the Government buys military equipment, or if the Government buys pencils, or if the Government buys the services of the civil servant or pays the soldier, the Government determines them end products or output. If the Government makes transfer payments, it merely gives money to other people to spend, and they can decide what to do with it. In our economics class we always say transfer payments are just negative taxes. They give money and taxes take money, it being decided by the individual how he wants to let this be reflected in his personal expenditures.

So I make the division here. There's a distinction between purchases and transfers. I find these figures. This, incidentally, is for calendar year 1962. One of the nasty things about fiscal data is that there is always confusion between ^{and} the calendar year/the fiscal year. The fiscal year, of course, runs from July 1 for the following 12 months. It differs from the calendar year. These dates are calendar dates. The budgets, of course, are on the basis of the fiscal year. So we

have here 62.6. Transfers are 47.3. We have a total of 109.9. At the state and local level we have purchases, 55. We have transfers, 3.8. The total is 58.8.

Now, then, if we look at what these things are for, ^{of} these purchases of 62.6 here, national defense in this year was 53.7. That is to say the other would be 8.9. You see the overwhelming importance of national defense among federal purchases. I mean, you are not far off if you think that the federal budget consists of buying things in the national defense context and making transfer payments. It is striking how unimportant the pencils are. And this also includes, of course, the salaries for this ever-growing, presumably, government bureaucracy, which is also in here. In this year are the welfare programs, social security, also interest payments on public debt.

One might ask how one would sort of try to separate these transfer payments. I sometimes have used a concept of related expenditures--national defense related expenditures, or security related expenditures. In this case some part of the transfer payments would also belong in this bracket (indicating). In a sense, I suppose, you could take the interest on public debt in there, because public debt, of course, except for some negligibly small fraction, was incurred in the course of war finance. Then there would be veterans' benefits and some things of that sort.

I think maybe roughly one might say that perhaps \$15 billion would be, let me say, defense related, and the rest roughly would be other. So, if you wanted to, you could take this 15 and the 52.7 here (indicating), and this would be roughly 70, or something like that. You could say that, of the total federal budget of this amount, the national defense objectives being sought would take over

two-thirds of the total. This, of course, is an extremely important thing to keep in mind, because, when people complain about the high taxes they are essentially complaining about the defense establishment at the federal level.

At the state and local level, just to indicate the main items here, they are education, \$21 billion, highway, \$10 billion--excuse me, they don't come out of there, they come out of here (indicating). Public welfare of various sorts amount to \$5 billion, and other, \$22 billion. This gives you some idea of what these things are for, and what these things (indicating) are for.

Now, then, on the tax side going now to the receipts, on the federal side we have the personal income tax. Incidentally, details of the federal budget you have on page 37, although not on the state and local budget. I think this is where these figures come from.

I might mention one very troublesom thing. It comes out when you look at your statistics here on page 35. You have federal finance and you have federal administrative budget receipts and expenditures. On page 36 you have the same story all over again, but it says "federal cash receipts from and payments to the public." On page 37 we have the federal budget--national income account basis. These are three different ways of looking at the same thing. The data which are given on page 35 show the administrative budget. That is the thing which Congress legislates on. For some purposes it is useful, and for some other purposes it really isn't too useful.

You see, the budget as shown on page 35 leaves out all the trust accounts, whereas the figures shown on page 36 and page 37 take the government as a whole, and they net out the transactions with the trust account and consider only actions with the public. Therefore, from the point of view of economic impact they are

more useful. The difference between the story on page 36, the cash payments, and the story on page 37 is mostly that what is given on page 36 is useful if you want to figure out how much more the Government pays to the public than it gets from the public, the difference being the change in public debt and cash balance.

If you look at page 37, we are not entirely on a cash basis. Here the government items are recorded in the way in which they enter into the national income accounts. The main difference is that on page 36 the receipts from the corporation income tax are on a collection basis, whereas on page 37 they are on an accrual basis. They move with profit liabilities, and that, of course, makes for a good deal of difference in the timing of the deficit and the surplus over the cycle, because profits fluctuate widely, and therefore corporation profit tax accruals fluctuate.

So one always has to watch out on what basis figures are presented. Of course this is a very tempting circumstance from the politics point of view, because, depending on what you show, you are always tempted to pick that concept which in that particular phase of the cycle makes the budget look better. Or, on the other hand, it depends on what you want Congress to do. You may want to scare Congress and you may want to make it look worse. Economists generally think that it would be much better to forget in general presentations pretty much the administrative budget and look at it in either cash terms or national income terms. But we don't want to go into that now.

Then, looking at the tax figures as they are given on page 37, we have personal income tax of 49.3, corporation income tax of 23.4, so-called indirect business tax, which is the excise and so forth taken together, of 15, and then

various kinds of social security contributions, of 20.5.

So you note, you see, the very great importance of the individual income tax, also of the corporation income tax, of both income taxes taken together. You may be aware that one of the arguments now being debated a great deal is whether our tax structure does not lean too heavily on income tax. Some people say, I think without much evidence, that the reason why Europe has gone so much faster than we have is that they have only sales taxes. I am not at all persuaded by it, but there is a lot of debate about this.

I might also add that this predominance of the personal income tax is something which dates from World War II. If you had gone back to the period just before World War II, I think the income taxes would have been maybe 20 or 30 percent of the federal budget level. That was a real revolution in our fiscal structure in the course of World War II--the rise in importance of the individual income tax.

Incidentally, the reason for this was not that we were more and more soaking the rich, because, for better or for worse, trying to "soak the rich," to use the sense of the thirties makes very little difference as far as the revenue of the personal income tax is concerned. The great bulk of the yield of personal income tax comes from the lower income brackets. About 70 or 80 percent of the total personal income tax revenue is derived by applying the 20 percent rate. The additional revenue which you get from these higher bracket rates makes very little difference, hurting though it may the people who have to pay it. If you were to cut back all bracket rates to about 50 percent, you would lose only a few hundred millions, which is practically nothing in terms of this \$49.3 billion. This is one of the things that in teaching public finance, or for that matter

economics, things don't really make sense unless they are over a billion or within the range of one salary, and one sort of loses the feeling for things in between.

Then we have the corporate tax. If we look at the tax structure on this side--and I don't really have the exact figures for this--I will try to improvise and give you the orders of magnitude. I think the property tax is about \$20 billion. This of course is still about 80 percent of the local revenue. Then the sales tax is about \$40 billion, mostly from the States. The personal income tax is \$2.6 billion. The corporation income tax is \$1.5 billion. Transfers from the Federal Government of various forms of aid, are about \$7.1 billion, and other are about \$12.5 billion. The total is \$67.7 billion.

I want to make the point, you see, that there is an extraordinary difference in the character of the revenue structure of the federal as against the state-local level. At the federal level you have essentially an income tax structure. The relative importance of the income tax is even bigger if you forget about this here (indicating) which in a sense doesn't really belong in the picture--these social security contributions. So, if you just look at the taxes available for general expenditures, income taxes are practically all of them.

At the state-local level, as far as local government is concerned, 80 percent or so is property tax. As far as State governments are concerned, you see, the sales taxes are extremely important.

Now, on the whole, of course, the income taxes tend to be progressive. The individual income tax is much the most progressive tax which we have, and the corporate income tax tends to work out more or less progressively. By progressive, of course, I mean that liability as a percent of income increases as

you move up the income scale. The taxes on the state-local side tend to be sales taxes, which tend to be regressive. The property tax may be more or less proportional until you get into the high income scales.

So the point is that the federal tax structure is much more progressive than the state and local tax structure. I think this undoubtedly is one of the important factors in the politics of federal versus state and local government. People talk about states' rights and the Constitution, and so forth, but in many cases, of course, they mean progressive income tax versus regressive sales tax.

The relative weight which will be assigned, you see, to the two tax structures in the future will make a great deal of difference for the nature of our tax structure, and by the same token the enormous rise of national defense requirements makes for a great increase in the federal relative to the state-local budget. After all, if there were no national defense, the federal budget would be maybe \$20 billion and the state and local budgets would be maybe \$70 billion. As it is, the federal is \$110 billion and they are \$60 billion. If it weren't for the national defense, these (indicating) would be our important taxes rather than these (indicating).

So the whole question of fiscal federalism has raised great feeling in the politics of the matter on the nature of the tax structure. I can say this really depends on which of the two tax structures you like. I think it is just a factor of political life.

Well, I would now like to erase this and take another moment to take a somewhat different look at this general picture. If the figures don't quite coincide, please forgive me. It is really more for the general order of magnitude, anyhow, that I am doing this.

I am again back in calendar 1962. What I would like to do for a moment is to draw a little diagram based largely on the figures on page 2 of your pamphlet, to sort of give a visual picture of the way in which the public sector fits into the economy. What I am doing is combining the federal with the state and local, because, as you see on page 2, there is just one government sector.

This is the way in which I do it. If it turns out that this is much too elementary--what I am going to do now--will somebody please start hissing and I will stop it. Sometimes this is quite useful. Let me put up here the consumer households, and also business. In other words, what I put up here is sort of income and expenditures of the private sector. I don't want to complicate it by separating business and consumers. The foreign sector is in there, too. I just want private and government.

Let me put down here the budget. This is now the budget really of federal, state, and local. Then I would like to say this. Let this here be production by business firms. Let this here be production by government. This is production by business firms (indicating); this is production by government (indicating).

Then you see I get the following things. Let me start my circular-flow diagram here somewhere. This line coming in here shows sales receipts. This line going out here shows payments. These are payments for the factors of production--quarter payments, wage payments, interest payments. These are payments which are made by private firms (indicating). These are payments which are made by government as producer. This is civil service, because, as we shall see in a moment, the Government, to the extent that it makes purchases, does two things: Either it goes to the market and buys products from private firms--airplanes from private aviation manufacturers--or it hires resources, such as civil servants,

and produces things itself. This down here shows the Government producing itself.

Now, then, the total of this, of course, combines into the total output of the economy, which is, of course, national product, the gross national product being \$554 billion. Then, this gross national product is paid out to consumers in terms of wages or in dividends or to business firms in terms of depreciation reserves or in terms of profit.

I am just combining all these to simplify matters. Then this private sector in turn goes and buys things from business. Consumers buy ice boxes, and ice box manufacturers buy machines with which to make ice boxes. That is what this is.

Now, the Government collects taxes. This circular flow goes like this. The Government collects taxes. Let me assume that there is only one tax, like one income tax. Let's lump all taxes together. These are taxes (indicating). These taxes flow into the budget as tax receipts. These here (indicating) are private purchases. Then in turn the Government makes expenditures. The Government makes two types of expenditures. As I said before, the Government makes transfers and the Government makes purchases. These transfers, as I said before, are nothing really but negative taxes. Taxes take money out of the income stream available to the private group. The taxes are taken out and the transfers put it back in.

Let me make this a little heavier, because this is sort of my basic flow. Now, then, as far as the purchases are concerned, the Government either buys things from private firms, or, as I said, it goes and buys labor and so forth, and then pays government wages.

So this, I think, is sort of a basic picture of what goes on. Let me put

the figures in. I am improvising a little, but they are about right. So we have a gross national product of \$554 billion. We have taxes of \$157 billion. We have transfer payments of \$44 billion. This means there is left up here \$4.2 billion. Then we have private purchases of \$437 billion. We may note, you see, that private purchases here fall short of total private receipts by \$5 billion. So what we do have apparently is net saving of \$5 billion up there, which is the difference between these two figures (indicating).

Then, on the government side, we have purchases here of \$117 billion, and transfers of \$44 billion. These purchases are divided into \$56 billion of buying things from private firms and \$61 billion of the Government itself hiring civil servants and producing things itself. So we have here, then, again 61, and we have here 316.94. I hope these things add up.

However, you see, you will find down here, if my figures were correct, that there is here a minus 5 on the government part. For this particular year expenditures exceeded receipts by \$5 billion, whereas up here (indicating) receipts exceeded expenditures by \$5 billion.

You can see very easily, if you set this up like you do on this page, on table II, that of course it is no accident at all that this \$5 billion here (indicating) is the same as this \$5 billion here (indicating). For the circle to close, for the accounts to balance, you see, if one sector spends more than its receipts, then the rest of all the sectors combined must ^{spend} less than their receipts, because, for the group as a whole, receipts equal expenditures.

If you look at the gross national product, which is the value of all goods produced, you look at total expenditures made on things produced. If you look at wages, profits, depreciations, et cetera, you look at all the income earned,

including profits from what has been produced. And of course one equals the other. The accounts balance. So quite obviously these two items must be the same.

I put this on the board just to give you an idea, which I think is extremely important, of the public sector of the economy as being an integral part of the total operation of the economy. The sort of notion which you get a lot in the newspapers that here is your economy, which is essentially the private economy, you see, and that then somehow this public sector is superimposed and is a drain on the private economy, I think is nonsense. They are both part of the national economy. Logically, we can just as well argue that the private sector uses income which is spent by government as that government uses income which is created by the private sector. It is an integral economic system. This has to be kept in mind.

Now let me briefly ask this question. With this factor in mind, what are the main problems which arise in the conduct of this public sector, or the main problem areas? Let me very briefly pose them. There are three. I like to think of three. You can also divide it into more. One really is: What are the public services for which the Government should spend money? What and how much for public services? How does one determine how large should the national defense budget be? How many highways should there be? How much should be spent on schools? Et cetera, et cetera.

Now, unfortunately, this is a difficult problem. Unfortunately, it is a problem which you do not have to face if you deal with the use of resources for satisfying private wants, because, if you deal with the use of resources for satisfying private wants in our economic system, we say, "Let the consumer decide."

If some ladies want green hats, they will go to a store and ask for green hats. If the store sells only red hats, the manager will tell the manufacturer that the consumers want green hats, and the producer will produce green hats. That is that. That is the way the price mechanism works. The consumer has to go into the store and has to bid for the goods. He has to be a bidder and think of the pricing system as an auction mechanism. The consumer is forced to reveal his preferences, because if he doesn't, and if he then does not bid, he just won't get what he wants, and the producer then adjusts accordingly.

In the case of public wants, you see, the problem is different. Let me just sort of make it a bit extreme. Take the case of national defense. I as a citizen am going to be protected by national defense whether I say I want defense or not. Suppose the Government in providing for national defense would ask everybody, "How much is it worth to you? What are you willing to pay for it?" and then send a bill accordingly. I might say, "It's worth nothing to me," because I might figure that when I contribute something it's because I know that if I say it is worth nothing I get the zero bill. I'm perfectly safe to say this because my contribution is such an infinitesimally small part of the total country's contribution that the amount of protection which I get has nothing to do with what I contribute.

Therefore, I don't reveal my preferences. This is the trouble that we have. You are not forced to reveal your preferences, because you get whatever you get independent of whether or not you contribute, because you are such a small part of the total.

Therefore, you see, you need the whole political mechanism, the voting system, compulsion by voting, to force people to reveal their preferences and

to determine what is an efficient use of resources for public services. This is where the whole theory of democracy gets into the picture. And therefore it is much more difficult to determine efficiently to what extent resources should be used for public services, because you need the political mechanism, you see, as against the market mechanism.

Now, while I think it is important to realize that it is more difficult, you see, this does not at all establish a presumption in the direction of saying that the use of resources for public services is less important. You know, it is just technically more difficult to determine how much should be used. But it must not be concluded that therefore somehow the use of resources for public services is inherently wasteful. This is quite a different matter. It is just more difficult to determine.

This is the whole, big problem. Of course you not only have it in defense versus civilian services but you also very importantly have it in defense. How do you make your choice, then, in allocating a given defense project between aircraft carriers and missiles? Et cetera, et cetera. In all these things, how is there to be an allocation between the services? This again is very difficult, because, how can the three services bid against each other, because they don't have the allocation of the total budget to begin with? Then you get it right down to different weapons, to different branches of the service, to different programs. It's all the same kind of issue.

This is the sort of area/ⁱⁿwhich, being a professor, I am obviously in sympathy with the Quiz Kids in the Defense Department. This is the sort of area which they come in, I think. They can be helpful in sort of trying to sort out how one thinks about this problem and how one can do something

about trying to get a more efficient allocation between different services and programs, in view of the fact that you don't have a market mechanism which does it automatically. This is one sort of problem.

The second sort of problem, it seems to me, is the problem of income distribution. Some people who I would say are taking a somewhat extreme view of the matter would argue that, if anyone says that public finances as such have something to do with income distribution, he is a Communist. This doesn't seem to me to be good reasoning. It's the question after all of, having decided on what resources should be used for public services, who is going to pay for them and how are they going to be released.

It's good and well to say, "Let people pay for them who want them." This is easy when it comes to toll roads. You can do it. But when it comes to broad public services such as national defense you can't, and, it seems to me, the question of "tax equity" inevitably arises. Does one like a progressive distribution? Does one like a regressive distribution? Does one think that taxpaying ability should be measured in terms of income or does one think that taxpaying ability should be measured in terms of consumption?

These are all questions where the answer depends on one's social outlook and one's attitudes, quite apart from economic effects, but they are answers which quite legitimately Congress has to concern itself with. Moreover, you see, there are these transfer payments which are just negative taxes. These transfer payments also, of course, affect income distribution. We have transfers from the young to the old; we have transfers from the healthy to the ill; we have to some extent transfers from the rich to the poor, and so forth.

I think everybody would agree that there has to be some degree

of transfer in society. Everybody wants to make sure that society looks after babies whose parents have been killed in an automobile accident. Everybody would say that there should be a transfer of milk to them.

Some people would go a little further, and some people would go much further. It is really a matter of degree. The point I want to make is that, if there is to be a transfer, it is much more efficient from the economist's point of view to do it through taxes and transfers than to do it through rent ceilings and minimum wages, et cetera, et cetera, where you are living in fear of the way in which resources are to be distributed. So it is this distribution and the whole equity aspect of tax and transfer policy.

Then, thirdly, there is the question of stabilization policy, namely, that the operation of the fiscal system has a good deal of bearing on how the economy functions. Now, one of the important bearings it has is what it does to the level of adequate demand in the economy. For instance, suppose that in the next year the system was in equilibrium. It has been going like that for a long time. Suppose that in the next year we cut taxes by \$10 billion. That would mean that this year it is minus 10.

Now I am sort of attaching time substance to it. The old figure is for the year 1963. The new figure is for 1964. So this goes down by 10 (indicating) and this goes up by 10 (indicating). If this goes up by 10 maybe this year (indicating) goes up by 1 and this year goes up by 9 (indicating). If this goes up by 9, then, presumably, this (indicating) goes up by 9, and then this year (indicating) goes up by 9. Now, in this year (indicating) suppose that there is no change here, and suppose that there is no change here (indicating). Then it would mean that this year (indicating) it goes up by 9, and then it would

mean that this (indicating) goes up by 9.

And then as it goes around again eventually the increase will be more than 9; it will be something like 20. This is what economists call the mud-pile effect. If, on the other hand, Mr. Burns wins, which God forbid, I think that for the economics of the matter, then, this increase of plus 9 here (indicating) would be matched by a decrease, let us say, of 9 here (indicating). If there is a decrease of 9 here (indicating) then there is no increase here (indicating).

So this is the argument for the tax cut, as a stimulant to the economy. Cutting this by 9 initially means that this year (indicating) it would go up to at least, initially, minus 14. Now, as this goes up to minus 14 of course the GNP rises. As the GNP rises, this year (indicating) we begin to get plus 5 here (indicating). You get about \$5 billion of taxes back because the GNP rises.

As you do this, minus 14 goes down to minus 11. Some people in the Administration like to present the thing in such a way as saying that, because we have the tax cut, the GNP will go up so much that it is a built-in gain, and that gains will not be plus 5 but will be plus 15, and that in the end, if we have the tax cut, we will be in a better budget position than we would be without it.

I think that this is extremely dubious. It could be so and it would be so if because of the tax reduction you got such a stimulus to investment that the whole economic scene would change.

I was told when I came in that this is strictly off the record. I think that to some extent the trouble that the Administration is now running into in Congress with the tax cut would not have happened if there had not been the tendency on the part of the Administration to use double talk on the issue. They

never felt that they could really come out and say, "We want a tax cut because we want a deficit, because it is the deficit that will expand the economy.

They always say, "If we want the tax cut we just can't sell a national argument by appealing to precisely the 'irrational element' which opposes it."

This is to a considerable degree what has happened.

Let me say a word here about the deficit aspect. If we have a tax cut now and if this would mean an increased deficit, this means that it will result in an increase to the public debt. In concluding I will say two more sentences regarding the public debt. I think there is no question that what matters is not the level of the public debt but the ratio of the public debt with the GNP. After all, if the level of output is higher, without going into an analysis, it is quite obvious that it can sustain a larger level of debt.

So what we should ask ourselves is really: What will the tax cut do to the debt and the GNP ratio? The point which I think can be made very easily is that this ratio of debt to GNP will go down as a result of the tax cut. In other words, the percentage increase in GNP will be greater than the percentage increase the debt goes up. That I think is quite enough to improve conditions. Unless we have that on the debt side there is no danger here (indicating). It is a ratio matter.

Perhaps you can say, "Well, I certainly sympathize with those poor fellows in the White House. Who is going on television to explain this to the American public?" This is probably so, but somehow I believe that democracy just is not going to function until we come to the point where we can explain these things. I don't believe that anything is gained in the longer-run policy by selling good policies with wrong reasoning.

COLONEL SMITH: Professor Musgrave is ready for your questions.

QUESTION: Professor Musgrave, why do you think that the Administration is seeking its objective of growth to additional spending through a tax cut rather than by deficit financing through public works expenditures?

DR. MUSGRAVE: The question is not why I think it should or should not be that way but why I think the Administration does it this way?

STUDENT: Yes, sir.

DR. MUSGRAVE: I think there certainly was, as one notices from the papers, considerable debate in the Administration as to how it should be done. Some people such as the former Ambassador to India have been heard saying that it would be better to do it through an expenditure increase. I think also that from what one can read for quite some time the White House was quite openminded about it. I think there are maybe two reasons why it was done this way. One was, you see, that there had been the hope of getting structural tax reform.

Now, when we, meaning my academic colleagues who work in the tax field, talked about tax reform over the last 20 years or so, what we mostly had in mind was to close loopholes and broaden the income tax base. There seemed sort of a chance that if you had tax reduction then you could have tax reform, because, if you have tax reform without tax reduction, then where A pays more B pays less, or if B pays less then A must pay more, but that, if you could have tax reform and tax reduction, then it would merely mean that A would pay less and B would pay the same. You know, you even out, you equalize, you get a more equitable tax base downward. There seemed to be this hope.

I think that this hope has really been completely shattered. I think that, instead of being able to have tax reform because you have tax reduction, you are

going to have disreform to buy a reduction. I think that has completely backfired as I see that part. I take a very dim view of the reform aspects of the bill. That is one point--the hope of tying in the reform. Certainly Secretary Dillon felt very strongly that this was the only way you could get reform. As you know, the President, in his presidential campaign, put a great deal of weight on the aspect of tax reform. That's one thing.

Now, another thing is that undoubtedly what you felt was that what you had to do was to convince the conservative wing of public opinion, because that is where the more serious opposition was. It just seemed that, in having a tax cut, this was the more conservative way to do it.

Now, in a way, this is not really so obvious, because, getting expansion through a tax cut is really a more naked counter argument, you know, than having more public works or things you need. It was felt, I think, that the public would respond better, and then you could reduce a high marginal rate, which was something the public wanted anyhow.

But, you see, this is precisely it. You always sell the tax cut by sometimes implying that you want it for the deficit's sake and other times implying that you want it because "taxes are unbearably high" for the economy to function, without ever mentioning the deficit aspect. So it really appealed to sort of two quite opposed economic philosophies, and it was felt that then it would go through. You see, from the one philosophic point of view, tax rates are unbearably high, and Mr. Burns' amendment makes perfectly good sense. If the whole point in the tax reduction is the incentive effect of reducing rates, then cutting expenditures at the same time is O.K. But, if the main emphasis is on the increased purchasing power through the deficit, then reducing

expenditures at the same time would completely nullify what was gained.

You see, there was always this appeal to these two sides. I think that probably there was also this feeling that, if we could get the economy to function better, then, after all, that would mean that just by the natural growth of the economy every year/ ^{or so,} GNP would increase by \$20 or \$25 billion simply as a matter of growth, and that, if that was the case, it would mean that perhaps every year, through the built-in effect of the federal tax yield, it would go up by \$5 billion. In other words, if you got the thing going, if you did all right, there would be a growth of tax yield, which over, let's say, the next decade or so, would supply plenty of revenue to meet the additional public needs.

We are now really sort of in the impasse. Of course this is based on the assumption that you people won't argue that you have to keep national defense as a percentage of GNP constant. If that were so, then this whole silver lining would disappear completely. But, if one could assume that national defense would remain constant absolutely, then the silver lining is very impressive.

I guess people always hope, even though they know better.

QUESTION: There is some indication that this tax cut might be result in the States increasing their taxes. I think that Governor Rockefeller indicated that he might renege on his promise of about a year ago. Could this be significant in adversely affecting this other cycle?

DR. MUSGRAVE: I used to think so, too, but the answer clearly is no. Let me give this illustration. How would an economist normally look at the effect of the tax cut? Suppose we cut taxkes to go down by 100, initially. Then that means that the disposable income of Mr. Jones goes up by 100, initially. That means that Mr. Jones will increase his consumer spending initially by, let's say \$90.

So consumption initially will go up by, say, \$90. Then, in subsequent rounds of income making its circle, there will be additions to that of, say, 45, 22.5, 11.5. In all this will net up to something like 180. I am taking a multiplier of 2. Maybe it should be a little larger. So, out of the tax cut of 90 we could get a GNP gain of 180.

But now suppose that you have the local government increasing its taxes. That would mean that the federal taxes would go down by 100, and state and local taxes would go up by 100. But you see, if I assume that state expenditures go up by as much as state taxes, this is a trick. If you grant me the assumption that state expenditures go up by as much as state taxes, then state expenditures are up by 100, and then we get a chain of 100 plus 50, etcetera, which will net up to 200.

So my answer is, you see, that, if this tax reduction is reflected in increased local taxes which are fully reflected in increased state-local expenditures, then we are going to be better off rather than worse off, because we are starting with what the economist calls multipliers--the thing is multiplied by 100 rather than by 90. So it is O.K.

QUESTION: You mentioned that it is difficult to explain this to the public. In your opinion, are the leading members of the leading committees in Congress fully aware of this, particularly Curtis and Mills?

Dr. Musgrave: I think the White House is aware of it. I think the Treasury is aware of it. I might say that I think Governor Rockefeller is aware of it. I don't know whether Senator Goldwater is aware of it or not. I would be surprised if he wasn't. I think when it comes to the congressional committees, I think they are not. I have serious doubts whether they are. I am sure, for instance, that

Congressman Curtis, of the Ways and Means Committee, who talks a great deal about these things and is quite sincere about them, refuses to accept the point. Of course he would have some arguments as to why he refuses to accept it. I think that, with due respect, on balance they don't accept it.

Wilbur Mills I don't really know. You see, some of these people on the Ways and Means Committee are extremely concerned with the reform problem rather than with the fiscal policy problem. Of course, on the matter of reform one must be aware that these people are subject to tremendous pressures, not only pressures from people in their own constituencies but from people all over the country. It is not so easy to deal with all this.

I really don't know whether you could sell it in Congress. I do think, however, that if you sort of look at the discussion today on the matter it certainly is much more enlightened, say, than it was in the twenties when these people started talking about these things.

But by and large, I suppose, in Congress there is not this awareness. The one sort of big mistake which my good friend, Walter Heller, made in his otherwise excellent tenure, was his slip about the Puritan ethics, which you probably remember. He made some remark, I think, in the Joint Economic Committee that it was so hard for people to accept this notion because of the Puritan ethics, you know, Puritan ethics basically saying that saving is good and deficits are immoral.

This is sort of part in many ways of the American cultural heritage. For an economist this is sort of a banned term, because there has been a good deal of writing on the effects of Puritan ethics on the growth of capitalism. This is kind of what he was talking about. But people took it as flaunting our ethical

values by some reckless new frontiersman. But I think that there is this difficulty, that, if it is so, then at least temporarily an increase in the gap between expenditures and receipts will raise the level of economic activity.

Then this is a fact which does seem to contradict the sort of things which the average hometown voter thinks are good and right. That makes it extremely difficult for the Congressman.

QUESTION: Sir, are you saying, in reference to the Puritan ethics which pretty much apply to the individual budget, that there are two sets of rules, one for the individual in terms of his own budget plans and one for the Government, one that is microscopic?

DR. MUSGRAVE: I think you can put it that way, yes. But, you see, this is not necessarily preposterous, that this may be so. After all, it is an economy of millions and millions of people who make spending decisions, who make savings decisions, who make investment decisions. It is certainly true.

I will put the argument in a way which every economist--I would almost have to say every reasonable economist--would agree with. Suppose that of these millions and millions of business firms and individuals who make consumption, savings, and investment decisions, it is perfectly conceivable that at any one time the investment decisions which are made, the decisions to spend money on something or other, are greater than the decisions which others make to save. This obviously may be so, because savers, you know, are not necessarily investors. Investors go to the capital market, go to banks, and so forth, to get money supplies.

So it is perfectly possible that in the economy itself there may be at some time an increase in the level of demand. There may be at other times a

reduction in the level of demand. There is no question that this can be so. Now, if there is an increase in the level of demand under situations where we have high employment, where our resources are pretty fully used, then you get inflation. This is bad. If at other times you have a decrease in the level of demand, this may give you unemployment, and this is also bad.

So it is simply not so, you see, that the functioning of the free economy is so perfect that there can never be excess demand or deficient demand. If you make all sorts of assumptions about complete price flexibility, et cetera, et cetera, you build a theoretical model, but this is not the way reality is.

Now, it certainly has been recognized for a long time--I mean in this country certainly for 50 years or so, since the beginning of the Federal Reserve System--that you meet monetary problems and that you need a monetary authority to control the public money supply. This is precisely the same sort of thing. You control the public money supply, because, if there is too much, you get inflation, and if there is too little you get unemployment. This is what the Federal Reserve System does.

Can there now be an alternative way of doing this? You can do it through the budget. There can be expansion either by easing credit or by increasing spending relative to withdrawal in the government budget. You can do it either way. And I think there is no question about that.

Now, if a person says, "I'd much rather do it through monetary policy, because, if I do it through the budget, I can tell people they can get public services for less than they really cost," then you encourage waste in the Government. Or, if, for instance, you want to be restrictive and have a surplus, then you make public services seem too expensive, and you again get misallocation. Then there

won't be any orderly decision as to what resources should be used publicly. I think that is a valuable, respectable argument. I think that makes sense. It infringes on the discipline action of taxes. So, if somebody, therefore, says, "I'd rather do it through monetary policy," I can see some point there.

But let me add now two considerations. One is that, of course, the Fed is not controlled by the Executive. The Federal Reserve Board can pretty much determine its monetary policy. Yet, under our system, nevertheless, it is really the President who has the responsibility now, under the Employment Act, to^a considerable degree, for how the economy does. The monetary tool is not really available to him.

Then there is the other consideration that, for balance of payment purposes, you simply could not engage in a really vigorous easing of credit, because the short-term interest rate would be too low and you would have an outflow of foreign funds, which would exaggerate the balance of payments problem. We just don't have available right now the monetary tool, and therefore the emphasis is thrown on this.

Now, there is the point that the mechanism of the economy may have its own logic and its own difficulties built in, and that therefore the answer may be yes. You see, I would put down these two rules of principle. I would say that the individual ought to live above his income or live below his income at any one time, in such a way as to, over his lifetime, spend his lifetime income, but, as between his youth and his old age adjust his time flow of consumption to his time flow of needs. I think when he just gets married he needs a house, he has a baby, and he needs a baby carriage, and it is all right for him to take up consumer credit. Then at other times when he has fewer needs, he ought to pay it off. That

is a rule for individuals, to adjust the time stream of your income use to the time stream of your needs, within the context of your given income.

I would say for the Government that what ought to be done is let the balance between tax receipts and expenditures be such as to maintain a stable, high-employment economy.

The answer is that the principles are different. The nature of things just isn't that simple. Now, I can make the second principle, and I think I could still say that my ethical philosophy is such that I favor prudence and savings. I think this is the good life, but circumstances are such that such and such a policy really is sort of liking it dry but living in a rain climate. You can't just adjust the climate to your preference.

QUESTION: In view of the overproduction in some industries and the unutilized capacity in others, and the unparalleled affluence of consumer goods and products and the facilities in this country, why does our fiscal policy emphasize an increase in gross national production, when there might better be a more rational use of resources and a more equitable/^{increase}in production, both national and international?

DR. MUSGRAVE: It's a nice question. I have a good deal of sympathy with it. I am not personally as thoroughly convinced of the growth argument as most of my friends are, and I sympathize with that point of view. But, look, I do think that accomplishing these objectives and having a more sensible allocation of resources domestically and internationally involves much more difficult and much more radical measures than having a policy which advances higher employment and growth.

This is the tantalizing thing about this. I can see people who think quite bitterly about whether income taxes help progress, on issues of interference with markets, and so forth. These are real issues on which reasonable men disagree.

But the tantalizing thing is that here you have an issue which is simply one of raising employment and accelerating growth, from which everybody has to benefit, and it seems a sheer--you can fill in the word--something or other that people don't get the point and don't cooperate on this, whereas these distribution and allocation problems, although they are very important, really, from the point of view of really basic public policy leadership, are more difficult to handle.

I would also say this, however, that I think ---if I may put in something quite extraneous--a personal sort of perspective of mine is that there is nothing that would help integration more than economic growth. I am perfectly willing to write zero on all the other aspects of economic growth and just look at it in terms of the integration problem and the urban juvenile delinquency problem, just these two things, and be completely indifferent as to what happens to per capita income in the United States, you know, and completely discount what I think is sort of a silly argument, this growth race with Russia, as if every native in Africa every morning reads The Bulletin on what the GNP is here and what it is in Russia. If I just discount all these things completely and just make it integration and the urban problem, there is really enough.

Society is more stable and society has an easier time in a growing economy. I think that. Having grown up in Europe myself, I think it is quite clear that on the whole the much happier social history of the United States, the quite different cause of the labor movement here, the absence of strong class elements, are all due to to the rapid growth and expansion of the abundance of resources.

I think, just for the sake of a more constructive solution to social problems, noneconomic, if you wish, that growth is extremely important. It is

something we ought to do in any case, if we just push in the direction of the other things. I think also regarding economic aid that the only way to keep the economic aid budget up is to be able to get more revenue by giving these lower tax rates, and so on. This is not perhaps intellectually very satisfactory, however.

COLONEL SMITH: I think we'll save the other questions for your visits to the section rooms, Dr. Musgrave. Thank you very much for a very interesting morning.