The Frank E. Seidman Distinguished Award In Political Economy

Acceptance Paper By
William S. Vickrey

The Other Side of the Coin

Award Bestowed September 24, 1992

RHODES COLLEGE
Memphis, Tennessee

The Frank E. Seidman Distinguished Award In Political Economy

Objective

The Seidman Award recognizes distinguished contributions to Political Economy by economists or other political and social scientists who, by conventional and/or innovative approaches, have demonstrated their dedication to improving human conditions. The Award seeks to honor scholars who have advanced general understanding of the roles of democratic values, public institutions, government policies, private enterprises, and free markets in promoting economic well-being and social welfare.

Selection Procedure

Each year nominations are solicited worldwide from the economics and social science professions. Following a defined process, the recipient is chosen by the Board of Trustees, acting upon recommendations of a Selection Committee composed of eminent economists appointed for limited terms. The Award is presented annually at a formal banquet hosted by the Award's Trustees and Rhodes College in Memphis, Tennessee.

The announcement of the recipient of the award will be made in the Spring by the Board of Trustees of the Award and by Rhodes College.

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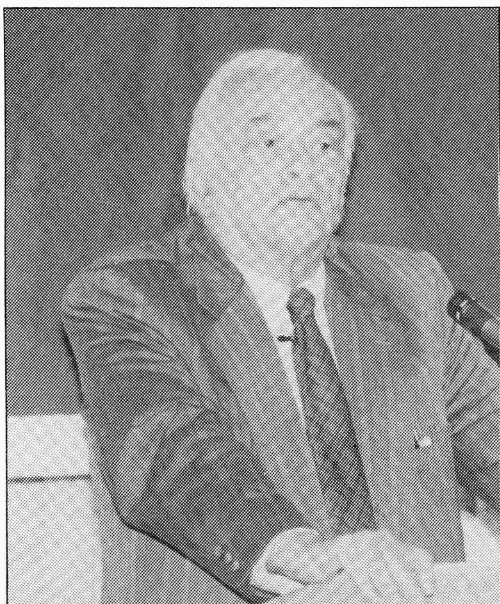

WILLIAM S. VICKREY
Recipient of 1992
Frank E. Seidman Distinguished Award
In Political Economy

PRESENTATION OF THE AWARD
BY JAMES TOBIN
NOBEL LAUREATE IN ECONOMICS
STERLING PROFESSOR OF ECONOMICS EMERITUS
YALE UNIVERSITY

President Daughdrill, Mr. Seidman, ladies and gentlemen, it is an honor for me to introduce to you William Spencer Vickrey, McVickar Professor of Political Economy Emeritus at Columbia University, currently President of the American Economic Association. I am proud to have served on the Seidman Award selection committee that enthusiastically recommended Professor Vickrey to the Board of Trustees.

Bill Vickrey has been at Columbia University, with some interruptions, since 1935. Few economists, few academics, have such long careers at a single institution. He went to Columbia for Ph.D. study in economics just after graduating from Yale — a wise move, I believe, given the state of economics at the time at those two institutions. It was a particularly happy choice for Vickrey and for the profession, because his 1947 dissertation under Robert Murray Haig, a leading public finance authority, was a classic work, republished as such in 1964. And Vickrey carried on, embodied, and strengthened Columbia's traditional eminence in public finance.

Bill, let me in turn introduce to you this audience. Memphis is a long way from New York and New Haven. But as you are finding out, your new friends are not only extremely hospitable but also deeply interested in political economy and its practitioners, among whom their tastes are sophisticated and discriminating. With the leadership of the Seidman family, expressed in the Award and in numerous other ways, Memphis is connected to the whole world of political economy.

The eighteen previous recipients of this Award have, each in his own way, made a significant contribution to the science, the art, and the practice of political economy. Bill Vickrey's contributions are equally distinguished, and they too have taken forms reflecting the recipient's unique interests and talents. I have long admired Bill's work, unhappily from a moderate distance (Yale and Columbia are separated by all of 75 miles) and without many personal contacts. I did not have the good fortune to be his student or colleague. In connection with this Award, I discovered that Vickrey's

contributions to economic theory and its applications were even more original, penetrating, and extensive than I had previously appreciated.

Indeed many economists of all ages agree that Bill Vickrey deserved much more recognition, much earlier in his career, than he received. The American Economic Association, which only recently chose him as its President, fourteen years ago honored him as one of its few Distinguished Fellows. The citation on that occasion expresses well the belated appreciation of his profession, and I would like to quote from it.

"Many of us have had the experience of thinking we were the first to publish this or that new proposition in economic theory only to find that William S. Vickrey had done it earlier — and whereas our "original contribution" contained... error, Vickrey had done it correctly. Some great scholars receive recognition from the beginning, but, inscrutably, with others it takes a little longer. His numerous works contain many seminal contributions, and many more that would have been seminal but for the fact that the profession was not yet ready for his ideas . . . We are proud to recognize the creative, inspirational, and persistently operational character of William S. Vickrey's contributions to economic theory and economic policy."

As a theorist, Bill Vickrey has been original, insightful, and elegant. He thinks more deeply than almost anyone else about the meanings and implications of the basic assumptions of economic theory. He uses whatever mathematics is useful for himself, his students, and his readers; after all, he majored in math at Yale. But he has never regarded mathematics per se as a substitute for logical thought, economic intuition, and common sense. His famous course in theory at Columbia was a gem, or rather a series of gems, opening the eyes and minds of generations of graduate students. Those lectures were the bases for Vickrey's two volumes on theory, micro and macro. They too are classics. Graduate students today, and their teachers, would learn more durable lessons from them than from fashionable contemporary literature.

Maybe Bill Vickrey could be described as a theorist's theorist, and some of his achievements, like an article on auction "markets" singled out in the full text of the 1978 AEA citation, do require experts to appreciate them fully. But pure theory was never Bill's main objective. He is an economist's theorist, certainly an applied economist's theorist, as well as a theorist's supplied economist. He seems always to have believed that the principles and analytical tools of economists can be put to work in the social interest.

His mind is always on potential applications — in policy-making, legislation, administration, and institutional architecture. The AEA citation rightly describes his work as "persistently operational."

Bill Vickrey is definitely not a simple admirer of laissez-faire who regards the proper work of economists to be explaining to a skeptical populace how the invisible hand of free market competition harnesses self-interested economic behavior to the maximum welfare of society. He knows it takes a lot of hard thought and hard work and ingenuity to design institutions that yield reasonably fair and efficient outcomes. Bill takes seriously theoretical conditions of economic optimality, like marginal cost pricing, and he tries to think of institutions that would approximate those conditions.

An example is his painstaking 1952 work on the fare structure of the New York subway system. Vickrey knew that the flat rate fare (a nickel at the time) could not be optimal. For efficiency, the fare should take account of the extra congestion a passenger causes. A passenger who rides to or from a heavy-traffic station during rush hours imposes more costs on the system and on other passengers than one who rides between remote stations in the middle of the day or at night. Vickrey was not content to point out this principle of welfare economics. He went into the specific details of the New York system and its traffic. He even worked out the engineering details of implementing a more rational system of fares related to marginal costs. Technology has caught up with him now. His suggestions would be much easier and cheaper to implement than in the 1950's. Vickrey also observed that it might save money to collect no fares at all at certain stations at certain times. Incidentally, Vickrey believed that it is not optimal to make the riders pay the full fixed costs of the system.

Vickrey has also been ahead of his time in advocating that users who congest roads and streets pay the costs they impose. At least twenty years ago he proposed tolls for driving in congested areas at peak times and worked out the engineering mechanics of recording such use by tamper-proof meters in each vehicle. They would be officially read at intervals, and the registered owner of the vehicle would be billed. Here, too, modern electronics and telecommunication technologies make his plan much more feasible. Some cities in Europe are beginning to charge tolls for entering downtown areas.

The bulk of Vickrey's contributions have been taxation, the field of his Ph.D. thesis, published as Agenda for Progressive Taxation, the classic I mentioned at the beginning. His work in design of taxes is at the same time

the most theory-intensive and the most practical of economists' prescriptions. He has treated extensively the taxation of income, expenditure, wealth, capital gains, business profits, and inter-generational transfers of wealth.

Let me just tell you one of his great ideas. Vickrey favors progressive taxation as a matter of equity, but he worries about the fact that progressive rate structure means that the same total income over several years will be taxed more if it is concentrated in one tax year than if it is spread evenly. This is unfair, and it creates uneconomic incentives to move income, at least in appearance, from one tax year to another. For this reason, tax code generally allow some averaging. Vickrey's proposal goes further. The IRS would keep for each taxpayer a cumulative account of income and tax paid. Each year you would be liable for a tax on your total income up to that point, and your previous tax payments would be credits against this liability. The ingenuity and simplicity of this idea are breathtaking. As soon as you hear it you are likely to say, yes of course. You will think of some problems, but you may be sure that Bill long ago thought them through.

In his own vita, Vickrey mentions with obvious pride an honorary degree Doctor of Humane Letters from the University of Chicago, and adds the following about himself: "The award that is posted on the door of his office, however, is the 'Rip van Winkle' award from the Center for Advanced Study in the Behavioral Sciences 'for deep and uninterrupted concentration while attending seminars.'" Spies at Columbia tell me that Bill attends numerous seminars throughout the university and rests with closed eyes for much of the time. However, he always does perk up, and then he at once offers the most cogent comment or blockbuster question of the whole discussion. Rip van Winkle, in contrast, was ignorant of what had gone on while he slept. Some say that Vickrey does sleep but keeps his eyes closed when he wakes up just long enough to capture the gist of the paper and discussion and to formulate his intervention. Perhaps only he knows, perhaps nobody knows the truth.

Well, Bill that time has come. I have the honor and privilege to present to you the 1992 Frank E. Seidman Distinguished Award in Political Economy.

THE OTHER SIDE OF THE COIN

by William S. Vickrey

A major decision-maker is reported to have pleaded "Find me a one-armed economist, who won't always be telling me 'on the one hand, but on the other'." Unfortunately for his search for simple answers, there are usually two or more sides to a question, and ignoring one side or the other runs a serious danger of making woefully wrong decisions.

Saving, Investment and National Income

More important for my purposes this evening, most economic transactions have at least two aspects, and much of our present plight is the result of looking at only one aspect and failing to follow through on the obverse aspects and their consequences. Nowhere is this more apparent than in the popular discussions of the levels of saving and capital formation and their impact on the health and growth of our economy. With the idea of promoting a desirable increase in investment in growth and productivity, we find an advocacy of various measures to encourage individuals to attempt to save more, ranging from tax advantages for pension plans, individual retirement accounts, and the like, to proposals to substitute sales taxes, consumption taxes, or value added taxes for part or all of the income tax.

Now it is true that in a world in which resources were being fully utilized, devoting more resources to capital formation requires that fewer resources be devoted to consumption, financed in the standard model by more saving out of the given amount of income being generated. In the classical full employment world the capital markets were supposed to adjust the rate of interest to assure the use in capital formation of whatever resources people decide to release by consuming less than their entire income.

Unfortunately we have not had anything like full employment of resources since the Korean War, or over the entire adult lifetime of many of you here. In spite of this the thinking of establishment economists seems to operate oblivious to the fact that there are idle resources waiting to be brought into play, much as in the tale of the economist marooned on a desert island with two colleagues faced with the problem of dealing with some canned goods washed ashore. After the physicist had wondered whether the

sun's rays could be concentrated so as to burst the cans, and the chemist had suggested that perhaps sea-water could be made to corrode them, the economist declared "the thing to do is just to assume we have a can-opener." But policies that might be appropriate on the assumption of fully utilized resources are simply absurd when idle resources of all kinds are waiting to be put to use.

The obverse of saving, in such a context, is non-spending. Savings are not like sacks of potatoes which if left unsold today will induce sellers to lower their prices tomorrow. For most people, saving more is not accomplished by working harder to earn more income but by spending less. Income set aside as savings, if not taken up by capital-forming activity or used to finance government outlays so that they are recycled into the income stream, simply vanish in reduced income to others.

If I were to respond to the tax advantages of IRA accounts by not having my hair cut this month, there will be eight dollars more in my bank account, but eight dollars less in the barber's account; there is no easing of the terms on which anyone can obtain funds with which to create capital. As Gertrude Stein remarked, "The money's always there, it's just the pockets that keep changing." Indeed, if the barbers react by reducing their consumption in an attempt to restore their saving to the previous level, the resulting reduction in consumer demand has a depressing effect on capital formation, further depressing national income. My attempt to save more may have been individually successful, but has resulted in a reduction in national income and total savings and investment. To ignore the fact that the flip side of saving is non-spending is to arrive at horribly perverse policy choices. Yet we find prestigious economists treating the problem by tacitly assuming that we are dealing with a fixed total to be divided between saving and spending, which is about as useful a basis for policy decisions as for the marooned economist to assume the availability of a can-opener.

The supply-side notion that "supply creates its own demand," a maxim often cited as "Say's law" simply fails whenever part of the income derived from the production of the supply is shunted aside as savings, without an effective mechanism to insure that the corresponding resources will be utilized for capital creation. Actually, if an entrepreneur obtains an extension of credit from a bank, possibly facilitated by expansion of the reserves provided by the Federal Reserve System, and utilizes it to hire unemployed workers to lay bricks and mortar, then if this is done prudently the capital created is additional wealth that will be directly or indirectly owned by

someone. This increase in wealth is ipso facto someone's savings. Instead of Say's law, we should have "capital creation generates its own savings." Saving, unless done by the one responsible for the creation of the capital, is neither a prerequisite nor a stimulus to capital creation.

Actually, capital creation does more than this. The masons employed on the construction site will not save all their new wages but spend most of them, setting off an expansionary spiral if people on the whole tend to try to save 10% of their income, then for every added $100 borrowed and spent for capital formulation, $1000 of additional income will eventually be generated, out of which there will be an additional $100 of saving to match the capital formation. This ten for one ratio is what Keynesians referred to as the "multiplier."

The Meaningless Nominal Budget

The conventional wisdom becomes even more perverse when one begins to talk of the true improvidence of government deficits and the burden of the national debt. As currently defined, the Federal deficit is not a useful measure of any economically meaningful quantity. The deficit as measured could be reduced, for example, by selling the Pentagon to a life insurance company subject to a long-term lease and repurchase option.

This would do absolutely nothing to the economy; one is merely substituting an obligation to pay rent in the future, which does not count as part of the national debt, for the obligation to service the bonds which were paid off with the proceeds of the sale. This, at least, is fairly innocuous; far more serious is the effect of pressure to reduce the deficit in inhibiting the filling of the oil reserve, or promoting the selling off of timber or mineral rights for immediate exploitation, thus diminishing the real heritage being left for the future, in the name of reducing a burden on the future consisting merely of a need for future transfers from future taxpayers to future debt holders. That the real resources are simply not there any more is a far more intractable problem for the future to deal with than the mere need to make the transfers involved in taxing to service the debt.

Capital and Current Account Budgeting

The basic trouble is that unlike all well-run businesses and many state and local governments, the federal budget makes no distinction between transactions on current account and those on capital account. If General Motors and AT&T had been required to operate with the kind of balanced

budget that is being recommended for the federal government we would have many fewer cars and telephones! (Do I hear some nostalgic pastoralists muttering that would have been a good thing?) And if individuals had been required to operate on such a balanced budget, mortgages would be outlawed and we would have many fewer homeowners. Only by distinguishing between capital outlays and current outlays can any sense at all be made out of a budget.

To be sure, there are, as in other contexts, problems as to what should be capitalized, for example to what extent should expenditures on child care and education be considered investments in human capital: even from a narrow treasurer's viewpoint, the government has an equity interest in earning power generated by education to the extent that tax revenues will be derived from it, even with unchanged tax rates. On the other side, there are the unfunded liabilities for military and civil service pensions, to say nothing of the knotty problem of how to handle the less definite but very large obligations to pay social security benefits that most individuals consider to have been bought with past payroll taxes. And the current accounts would have to include rental charges for the use of previously created capital, to cover interest and amortization, depreciation, or obsolescence.

The Recycling of Excess Savings Through Deficits

Under conditions of underemployment of resources, however, the far more important flip side of the federal budget is its function in recycling attempted savings into the income stream so as to prevent their being lost in reduced sales, production, and income. From the standpoint of the overall economy, savings are a highly perishable entity. To the extent that private capital formation is insufficient to take up and recycle what individuals attempt to save, it is imperative that governments borrow the remainder of these attempted savings and return them to the stream of purchasing power in order that the flow of income be maintained. For purposes of maintaining the level of national income and employment it is irrelevant whether the recycling be in terms of payments for current services or for capital formation, though it is ideologically much neater and perhaps more acceptable politically if the savings thus recycled go into capital formation rather than current services.

Recycling Savings Through Taxing and Spending

Even a program of "taxing and spending" so vigorously attacked by conservatives can contribute to the recycling of savings, to the extent that income taxes especially are paid in part by reducing savings. As these savings are taken in taxes and paid out in purchasing power, the multiplied stimulus to the economy may eventually increase aggregate real income by an amount approximating the total additional taxes paid, so that the added government expenditure is in effect met out of additional income produced, leaving no net added burden on taxpayers as a whole and no added national debt. This process is sometimes referred to as the "balanced budget multiplier." To be sure, the effect is very much weaker than the multiplier effect of outlays financed by borrowing, but yes, Virginia, there is a free lunch!

Past Deficits and Unemployment

Recycling of savings into market demand through government borrowing and spending is thus necessary, when private capital formation is inadequate to achieving a prosperous level of real national income, but can it always be sufficient? Indeed it is easy to point to periods in the past when seemingly large deficits failed to produce a full utilization of resources. In the 1930's, for example, deficits were large relative to the size of the government of that day inherited from the parsimonious regime of the Coolidge-Hoover era, but were still much smaller relative to the national income than would have been required to recycle the excess of what individuals would want to save out of a full-employment level of income, over what would be taken up and recycled by private investment. Deficits were widely regarded as something to be minimized and overcome, and tax rates were increased drastically in an attempt to keep deficits down.

Although there were references to kicking the economy off dead center, and analogies to "Pump-priming" where the pouring of a small can of water into the pump cylinder could seal the piston and enable water to be drawn from the well, implying that somehow homeopathic doses of purchasing power injected into the system could work wonders, it was not until the publication of Keynes' General Theory in 1936 that the recycling function of the deficit began to be understood by the substantial vanguard of economists. What stimulus to the economy there was in the deficits of the 30's was to a large extent offset by tax rate increases, and a pervasive pessimism associated with an animosity among the financial community against "that man in the White House." It was only with the outbreak of war

in 1939 and the large deficits that followed that a reasonable approach to full employment was achieved.

While the Keynesian analysis gradually became fairly widely accepted among the liberal wing of the economics profession, it tended to be treated as a left-wing heresy tainted with socialism by the bulk of the financial establishment. Deficits sufficient to drive unemployment down to between 2.9 and 3.3 percent were justified as a concomitant of the Korean War, and to between 3.5 and 3.8 percent for the Vietnam War. But outside these wartime periods, unemployment was allowed to remain above five percent, ranging up to and overall rate of 9.7 percent in 1982, partly because of an ideological demand for reduction of a misleadingly defined deficit, and partly by reason of a fear that large deficits would inevitably result in an acceleration of inflation to unacceptable levels.

The Development of Inflation Phobia

Fear of inflation was given increased force by the acceleration of inflation beginning in 1966, and especially by the OPEC-induced bursts of 1973-4 and 1979-80. Inflation began to be considered an evil comparable to unemployment. Indeed a "discomfort index" was even concocted by arbitrarily adding the annual inflation rate to the unemployment percentage. In terms of a majoritarian polity, indeed, fear of inflation tended to dominate the decision-making process. For while unemployment at levels of up to say six or seven percent has an impact heavily concentrated on minority groups, with the majority and especially the influential elite holding relatively secure positions hardly affected at all, at least directly, the impact of inflation is felt fairly universally, with many having very exaggerated notions of the adverse effects of inflation on themselves.

Misconceptions About Inflation

There is, indeed a tendency in the popular mind to think of inflation primarily in terms of increases in prices being paid, and to ignore the flip side of offsetting effects on wages and other receipts. Many seem to think in effect that if only prices would stop rising their income would go further. But, as long as total output is maintained, losses to some will be counterbalanced by gains to others.

Advantages of Moderate Steady Inflation

Objectively, measured in terms of impact on the general welfare, inflation

at the rates that have been experienced in the United States is a far less serious problem than unemployment. Indeed, a steady, moderate and reliable rate of inflation can be adapted to by adjustments to nominal interest rates, and in the formulation of long term contracts involving money payments. Minor "menu costs" involved in more frequent price adjustments and changes in accounting practices may be incurred, but on the other hand, such a steady inflation can actually confer advantages in increasing the scope for monetary policy in countering downturns in the economy, as well as increasing the base of the income tax so as to make it possible to have greater yields and greater progressivity with lower marginal rates and more moderate disincentive effects.

With a policy of maintaining inflation at a steady five percent rate, for example, it would be possible for a monetary authority to make financing for capital formation available at four percent to say seven percent nominal interest rates, corresponding to real interest rates from minus one percent to plus two percent, serving as a powerful tool to promote capital formation in an economy threatened with a downturn. And an income tax based on nominal accrued income would be equivalent to a tax based on real net income plus a percentage of net worth. While this is not what is meant by an ideologically pure net income tax, it is an excellent tax viewed in terms of its actual consequences.

Unexpected Changes in Inflation Rates are a Minor Problem

The real difficulty with inflation is thus not with its level, but with its uncertainty. Unanticipated changes in the rate of inflation, either up or down, disappoint expectations and result in arbitrary and often inequitable redistributions of given aggregates of wealth and income. Unemployment, in contrast, involves a reduction in the total product to be distributed. Briefly, variations in the rate of inflation amount to a form of authorized embezzlement, whereas unemployment is akin to vandalism.

Inflation Versus Unemployment

The even graver consequence of inflation lies not in inflation per se, but in the measures taken to control it. Under the current set of economic institutions, attempts to combat inflation by either fiscal or monetary measures operate ultimately through increasing unemployment. Indeed economists have in recent years begun to talk in terms of a "Phillips curve" which relates the level of unemployment to the rate of inflation, and of a

"Non-inflation-accelerating rate of unemployment", or NIARU, below which unemployment cannot be pushed without generating unacceptable inflationary pressures. This NIARU has in some circles been dubbed the natural rate of unemployment, in one of the most vicious euphemisms ever coined, and economists have even gone so far as to call this "full employment."

This NIARU depends to a considerable extent on the socio-political-technological climate within which the free market system operates. It tends to be lower in countries with a more homogeneous population, such as the Scandinavian countries. It also appears to have been increasing over time as the competitiveness of markets has diminished with the increased differentiation, real and factitious, of products and their associated services, the consequent greater degree of control of sellers over the prices of their products, and their inherent incentive to try to push prices up when demand strengthens, and rather than being compelled by competition to keep prices down and increase quantities sold.

Currently in the United States this NIARU appears to lie in the range of four to six percent. But while this might be barely acceptable if it meant that everyone would be required to take an additional two weeks annual vacation without pay, when it translates into rates of twenty, thirty, and forty percent in various disadvantaged groups, with consequences for poverty, ill health, homelessness, drug abuse and crime, it is totally unacceptable as a final goal of economic policy. A truly efficient level of unemployment would be one where anyone not too finicky about the job he or she is willing to perform would be able to find a job at a living wage almost immediately, with unemployment of one percent or two percent being limited to those with specialized skills, such as actors, athletes or construction workers waiting for work on a project suited to their talents. Another way of specifying such a state is to require that there be as many vacancies waiting to be filled as there are unemployed.

Advantages of Chock-Full Employment

If one could get unemployment down to this level the wages and status levels attached to menial but necessary jobs would be raised. Getting unemployment down to such a level would go a long way towards abating problems of poverty, homelessness, malnutrition, poor prenatal care, drug addiction, and crime. In the context of such a level of unemployment the difficulties with closing superfluous military establishments would be much

less critical. And while at current unemployment levels attempts to attack the problem at an individual level by retraining and similar measures often merely push the favored individuals to the head of the queue without reducing the length of the queue, as full employment is approached such measures would become useful and even essential in abating structural mismatch between job requirements and individual qualifications.

Difficulties in Moving to Chock-Full Employment

But how can we move towards this goal? Unfortunately, the rhetoric of the establishment has thoroughly sold the American public on the virtues of reducing the deficit even to the point where a proposal for a balanced budget amendment, that would have condemned the country to a painfully slow and partial recovery, obtained the support recently of a majority of the House. This occurred in the face of a circular opposing the measure signed by some 447 economists including seven Nobel Prize winners, eleven former and current presidents of the American Economics Association, and four recipients of the Seidman Award. To be sure, there was considerable variation in the signers' basis for opposition: some doubtless were chiefly opposed to putting the provision in the Constitution, and others would argue for various specifications of a balanced budget at cyclical peaks or over a long run average. But this opposition was about as close as one can ever expect to get to agreement among economists.

At the same time the financial and monetary establishment has taken a stance of being ready to slam on the brakes at the first sign of increasing rates of inflation and even subscribing to a longer run objective of ultimately reducing inflation to zero. Together with the inveighings against increased taxes, and in favor of curtailed deficits, an atmosphere has been created in which a candidate espousing a really effective program for achieving full employment would be in grave danger of losing the election. In this atmosphere few investors if any are likely to hold sanguine hopes of substantial early recovery, a self-fulfilling prophecy of gloom that is going to be very difficult to change.

Abolishing the Corporate Income Tax

Even those partial measure towards full employment that fall within the classical prescriptions for an efficient economy are likely to encounter at least inertia and often entrenched opposition. One minor but important step would be the elimination of the corporation income tax, or at least of

the double taxation of corporate income, which is a far greater hurdle in the way of capital formation than any effect attributable to capital gains taxation. Indeed, it would be in order to offset the immediate revenue loss in part by bringing the taxation of capital gains up to the level of other forms of income, to create a level playing field that would encourage the efficient allocation of investment resources. In the longer run the stimulative effect that elimination of the tax would have, could well result in a revenue increase rather than a decrease.

The corporate income tax indeed inflicts a double whammy on the economy, in that it not only withdraws funds from the circuit of purchasing power but in addition discourages investments that require equity financing, cutting back on the recycling of savings. In addition it encourages operating on thin equity with increased risk of bankruptcy and the associated costs and inefficiencies. It lubricates leveraged buy-outs and other mergers and reorganizations of dubious underlying merit. If substituted on a revenue neutral basis for other taxes, it results in unemployment, while if introduced together with an increased deficit sufficient to maintain current employment, the ultimate burden falls on future wage-earners whose productivity is impaired by having less capital to work with.

Nevertheless, the tax enjoys a fatal political popularity, in that nearly everyone firmly believes that it is paid by someone other than themselves. The naive public may imagine that it is paid out of some stock of funds buried in corporate coffers, corporate officers consider that they pass the tax on as a cost to their customers, and stockholders won't buy stock unless the returns promise to be comparable to those available from other types of investment. Some of the political opposition might be mitigated by converting the tax to a withholding tax on corporate income without the deduction of interest payments, at a rate corresponding to an initial individual tax bracket from which the dividends and interest paid to individuals would be exempt. To make things come out neatly, any tax at this initial "normal" rate paid by individuals on other income would be deductible from the base for the applications of the graduated surtax on upper brackets.

Dealing With Tax-Exempt Bonds

Another measure that might improve allocation of investment funds would be to convert the exemption of government bond interest into a taxable tax credit at a rate which would maintain the market value of the

bonds, so that the full loss of federal revenue would accrue to the issuing governments without offering high bracket taxpayers a tax shelter that might lure them away from investing in more productive risky ventures.

Taxing the Rental Value of Owned Homes

A more important but more controversial measure to improve the allocation of investment would be to require homeowners to include the rental value of their homes in their taxable income. The present tax law discriminates severely against renters and in favor of homeowners, especially those in the top brackets. For example, if a renter who has securities yielding income with which he pays rent were to sell the securities to buy his home he would find his income reduced by the amount of the rent. Eliminating this discrimination in favor of home ownership and against renters would have several advantageous results. The progressivity of the tax would be improved: renters represent over sixty percent of the bottom tenth of the income distribution, but only fifteen percent of the top tenth. There would be a better pattern of tenure when this is not distorted by tax considerations: The popularity of co-op and condominium luxury apartments is not primarily due to any inherent advantage in these forms of ownership, but largely to the associated tax advantages. Jockeying between landlords and tenants over the distribution of the tax savings resulting from conversions is provocative of some of the nastier aspects of landlord-tenant relations. Persons whose careers involve frequent moves are disadvantaged by not being able to rent on favorable terms and being faced with the higher costs of repeated purchase and resale. The wealthy especially are given strong inducements through higher marginal income tax rates to purchase extensive estates, and in many cases multiple residences, cutting into the land and other resources available to renters and low income households.

Nevertheless, this discrimination has strong popular support especially among the influential middle and upper classes, evidenced by the fact that, when in order to enlarge the income tax base, restrictions were imposed on deductions of interest on consumer debt, home mortgages were exempt, giving rise to an entire industry of offering home equity loans with which to refinance outstanding consumer debt, an opportunity denied to renters, especially those under financial stress. Much is often made of the political desirability of inducing voters to sink their roots in the community, with a subliminal agenda that this would lead those thus sinking roots to become politically more conservative. But if such an incentive is desirable, the

income tax discrimination is inappropriate to the job: it is small or non-existent among those not likely to be itemizers, and especially large for the owners of multiple luxury estates who characteristically flit from one place to another.

The same principle could be applied to car ownership. This would abate the discrimination involved in the present law in favor of car ownership as against renting, leasing, or using public transportation. To go further and attempt to include imputed income from furniture and other consumer durables probably is not worth the administrative difficulties involved, especially as there is very little substitution between these items and substitutes that are taxed.

Shifting the Property Tax to a Site Value Basis

Another tax adjustment that would encourage investment would be to change the property tax from a tax based on the entire value of real estate to one based on land or site values only. This would remove not only the current tax burden from new construction, but the overhanging burden of whatever local government debt will have to be serviced from future taxes on property. While it may no longer be possible to claim, as it was in Henry George's day, that taxes on land could be sufficient to finance all government activity, most of the locally oriented activity that contributes to urban site values can be equitably and efficiently financed by a tax based on site value, including, indeed, in the ideal case, much of the cost of distribution networks for water, gas, electricity, telephone, cable, transit, mail pick up and delivery, and even fire protection.

Efficient Utility Rates Financed by Site Value Taxes

Indeed, occupancy of land for tennis courts, for example, that do not directly use any of these services, nevertheless uses land that is provided with the availability of these services at a cost of passing the services past the property. The operator of tennis courts should no more be excused from paying for these services if he wishes to operate on land in the middle of a community where they are provided, than you should expect to be able to go to your favorite car rental agency and get a reduction off the rental because it is a fine day, you are not going to drive at night, and you have no use for the headlights or windshield wipers, (to say nothing of the back seat if you are going to be by yourself). Cars do not come without headlights and windshield wipers, and land convenient to tennis players is not found

without utility services running past. It is peculiarly inequitable for the owner of a two-acre estate to expect those living in row houses on 50-foot lots to pay a large part of carrying the utility services past their property.

Actually, if site owners could recognize their own long term interest, it would be to their advantage to increase their taxes to subsidize the services that contribute to the value of their lots, so as to enable rates to be set at levels encouraging efficient levels of utilization. In the not too long run the increase in the efficiency with which these services are utilized would result in the rental value of their property increasing by more than the required subsidy.

Unfortunately, as an element in a national policy of stimulating investment, shifting to site value suffers from being in the hands of state and local governments and might in some cases require constitutional changes. Federal measures might be taken to encourage such a shift, but it is likely to be slow and not likely to be a significant factor in the current crisis. And as a federal tax, there is a question as to whether its use would be barred by the Constitutional requirement that "direct taxes" be apportioned according to population, while the effect on investment might be minuscule as the main effect is not due to the site value tax per se, but rather to the reduction of the tax on improvements.

Advantages of Public Debt With a Site Value Tax

Another possibility created by shifting to a site value tax is that the financing costs of the community can be reduced by increased government borrowing, even for current expenses, enabling site owners to pay off mortgages or otherwise invest the amounts not paid in taxes. Interest rates paid on the government debt will be significantly lower, usually, than the rates on individual mortgages, or the returns on investments available to individuals, so that everyone in the community will be better off. Here is a situation in which the greater the government debt the better off the taxpayers are in the long run, up to the point where the market begins to downgrade the government bonds or there is insufficient margin of borrowing power left to deal with possible emergencies. On the other hand if rational property owners regard their share of the community debt as the equivalent of a mortgage, there will be no savings recycling effect. Deficit finance does not always recycle savings, especially if the tax system is dominated by levies on capital.

The Weakness of Stimulus Through Low Interest Rates

A more conventional means of dealing with a sluggish economy is through the reduction of interest rates and the easing of conditions for the extension of bank credit. There is, however, a limit to what can be done in this direction. Even zero interest rates can be insufficient to induce private construction of new plants or expansion of capacity when existing plants are being operated below capacity or even shut down entirely. At most, lower interest rates may encourage investment in new types of facilities or development of new products, but most such investments as these that are really promising are not on a margin where the rate of interest is likely to be a critical factor.

The Need for Recycling Via Debt

All of the above measures together are likely to be inadequate to bring the rate of unemployment down even to the NIARU level within a desirable short time-span, let alone to the efficiency level. This leaves increasing the deficit as a necessary means to a satisfactory reduction in the level of unemployment, and brings us head on up against the widely proclaimed virtues attributed to deficit reduction. Some of this ideological opposition to deficit finance may be countered by converting to a capital budget, balancing the current account budget, and relying on capital outlays financed by borrowing to furnish the needed stimulus to the economy. If the category of capital outlay is sufficiently broadly interpreted, there would seem to be no dearth of worth-while capital investment opportunities available, although many of them are in areas traditionally considered to be primarily the responsibility of state and local governments, such as education, and highway and bridge repair and construction. While this can still be handled through grants in aid and matching grants of various kinds, it may introduce a problem of timing, since it will in general be more difficult for a federal government to exercise close control over the time at which the actual outlays are made by the state and local governments. It would help considerably in controlling the timing if the outlays were not restricted to capital outlays but could also be made for current account services and projects, though even here rapid expansion and contraction of the scale of operations is often difficult.

Difficulties With Tax Reduction

The other side of deficit financing, tax reduction, has difficulties of its

own. If a tax cut is announced as temporary, many medium and high income taxpayers will treat this as a temporary windfall and tend to put a relatively small amount of it into added purchases, resulting in relatively little stimulus to the economy. To be really effective the tax cuts would have to be concentrated on the lower incomes that are under strong pressure to spend whatever is made available. This in practice means reducing payroll taxes, which raises the problem of the association of these taxes with pensions and other benefit payments.

If the reduction is not specifically temporary, however, this will tend to make it difficult, given the popularity of the "no new taxes" slogan, to increase revenues eventually to finance added debt service plus needed government services. This may please those who are ideologically committed to minimal government and the elimination of "government waste" (though not, in many cases, to the reduction of the most flagrant wastes of all contained in the maintenance of the military-defense industry complex) but it does require consideration of the long-run prospects. Changing tax rates may require less lead time than changing the level of outlays.

On the other hand, changing tax rates generates many significant arbitrary discriminations and added administrative difficulties, unless indeed a major change is made to putting the income tax on a cumulative basis, which could make it a matter of relative indifference how income is allocated to different tax periods. This would permit over half of the internal revenue code relating to such matters as depreciation rates, definition of capital gains, expensing versus capitalizing, and the like to be eliminated. Such a major simplification of the income tax seems to be resisted by the tax techies who make a living out of its complexities and by Congressmen fond of using the tax code to confer benefits on special interests. Short of such a major overhaul, tax reduction appears to me to be on the whole not the way to go for the present. Further, what ever deadweight loss there is to having a growing debt depends not so much on its relation to national income but its relation to the productivity and quality of the tax system. Lowering taxes to recycle savings thus poses a danger of making it ultimately more difficult to deal with debt service.

Getting Unemployment Below NIARU

At the most optimistic, such measures might serve to get unemployment down painfully slowly to the NIARU level of 4 to 6 percent, at which point further progress is likely to be blocked by a resurgence of inflationary

tendencies that would provoke vigorous opposition by monetary authorities to further stimulative efforts, implemented if need be by sharply increased interest rates, and even cause a backing off on the budgetary side. The basic difficulty here is that the macroeconomic measures currently available are inadequate to bring the economy to a satisfactory state of full employment. In effect there are three dimensions of the economy that one would like to control: the level of unemployment, the rate of inflation, and the division of total output between current consumption and capital formation with a consequent effect on the rate of growth of the economy, whereas there are basically two available dimensions to macro-economic policy: control of aggregate purchasing power through fiscal policy, and control of private investment through interest rates affected by monetary policy. This is like trying to fly an airplane without the ailerons that were the basic invention of the Wright brothers. At best, control is imprecise, and if bad weather is encountered there is danger of a crash. We lack a means of controlling the way an injection of purchasing power is divided between buying more goods and paying higher prices. Some method of controlling inflation is called for that does not create an inefficiently high level of unemployment, maintaining what Marxists used to call the "reserve army of the unemployed."

Difficulties with Peace-Time Controls

In temporary emergencies such as wartime, the problem has been fairly well approached, if not fully handled, by the imposition of an elaborate system of controls over a wide range of specific prices. But while this works as a temporary measure during wartime, in part because of the willingness of the populace to go along with such measures as a matter of patriotism, this becomes unsatisfactory as a permanent solution. As long as the emergency is short, reliance on the continuation of the previous pattern of prices can be made to work, but over time these prices get more and more out of line with the requirements of efficiency. There are also problems created by the modification of products and the introduction of new products, which make it difficult to adjust prices appropriately.

Anti-Inflation Incentive Plans

Over the last three decades a number of schemes for anti-inflation measures have been proposed, but the most of them have involved the administrative headache of determining when prices of individual products

have been increased, and many have involved some form of credit or adjustment of the corporation income tax, itself a rather poor base from which to start, as I indicated earlier. Economists should not give up that easily, however, if they are to earn their keep.

Lerner's Market in Rights to Raise Prices

My own solution to the problem builds on an idea promoted by Abba Lerner shortly before he died, that there should be a free competitive market in rights to raise prices, with those wanting to raise their prices having to buy the right from those willing to lower theirs. In this way the general level of prices would be kept constant without imposing rigid controls over individual prices, permitting them to vary in response to conditions in the various markets. This overcomes the problem of how to adjust the anti-inflationary pressure from time to time, as this would be adjusted automatically by the market. It does involve the problem of determining when prices are changed in the face of constant changes in product quality, new products, and variations in the terms of sale such as service, reliability, tie-ins, and the like. More fundamentally there is the problem of how to handle cases where a firm finds the prices of it suppliers increasing.

A Market in Rights to Gross Markups

A similar problem arises with gross receipts taxes which discriminate in favor of vertically integrated operations and against operations where a product will pass through several hands on its way to the market. In Europe, this has been dealt with satisfactorily by shifting from sales and gross receipts taxes to a "value added" tax based on the gross markups of sales over previously taxed inputs. This suggests that Lerner's concept be implemented in terms of free competitive market in rights or warrants to gross markups. Warrants would be issued to firms on the basis of gross markups in a corresponding preceding period with adjustments for changes in employment and invested capital. Firms experiencing favorable changes in their cost structure and lowering their prices accordingly would have excess warrants to sell to those with unfavorable experience needing to increase their prices. A firm ending the accounting period with gross markups exceeding what it has retained or purchased warrants for would be subject to a penalty tax. However, this penalty tax would not be expected to be a significant source of revenue, only an enforcement measure, the tax being set somewhat above the market price at which the markup warrants for the period were trading.

Gross markups would be determined in a manner comparable to those used in assessing value added taxes in Europe. Adjustments for changes in employment could be based on social security data, and for investment on income tax data. There seems to be no serious problem of administrative feasibility. These adjustments would be determined in such a way that the aggregate of warrants issued would correspond to the aggregate sale price of the product expected from the factors employed at a desired level of the general price level, thus bringing inflation under full control independently of fiscal and monetary policy.

Getting to Chock-Full Employment

With the general price level thus under firm control, stimulating monetary and fiscal policy can be resorted to produce a rapid growth of real national income. If we suppose that the reported rate of unemployment of 7.5 percent or so could be reduced at a rate of two percent per year as happened from 1950 to 1951, reaching 1.5 percent after three years, and we assume that, according to "Okun's law", each one percent reduction in reported unemployment corresponds to a 2.5 percent increase in net national product, we would have a five percent increase in income derived from two percent decrease in unemployment, and adding three percent for increases in the labor force and in productivity, we get a growth rate of eight percent a year for three years, after which growth would have to be limited to the two to four percent available from labor force and productivity increases. This would allow for the increased product derived from those not now included in the official unemployment figures, including part-time workers wanting full-time employment, disguised unemployment of those nominally at work but not adding proportionately to product, and for discouraged workers not reported. Alternatively we might be able to reach full employment in two years after growth at ten to twelve percent.

It would be rash to attempt to predict what the time pattern of policies would have to be to produce this result, which represents a reasonable program for the full utilization of the real resources available to us. What econometric models we have are calibrated in terms of regimes that differ significantly from that here proposed, and are not to be relied on, especially as so much depends on what Keynes aptly termed the "animal spirits" of the entrepreneurial community. I am tempted to expand the remark attributed to Mark Twain to the effect that there are "white lies, black lies, damned lies, and statistics" to add "and then there is econometrics".

Nevertheless, I think I can sketch in a general way the pattern to be followed. Initially there would have to be a massive initial push, in terms of a deficit at the rate of ten to twenty percent of GNP, approaching the levels that were effective in World War II in bringing the economy to full employment, depending on the speed with which the needed outlays can be organized, possibly in terms of a temporary suspension of payroll taxes. How long this stimulus would have to last and what happens next would depend on how this push is viewed by those responsible for deciding on capital formation. At one extreme they might be frozen into inaction by alarming projections of the growth of the government debt, in which case paradoxically it would become necessary to continue the high deficit and enlarge the debt that is being feared. More rationally, if they were to become convinced of the resolve of the administration to proceed rapidly to a full employment economy, and begin to realize the effectiveness of the markup warrants scheme in curbing inflation, they would begin to expand private capital formation so as to absorb a higher fraction of the increased savings being attempted out of enhanced incomes, leaving less recycling to be done through the government deficit. The deficit in turn will be subject to substantial automatic reduction through increased tax revenues from rising income and the reduced outlays for unemployment compensation and welfare.

If these effects are strong enough, indeed, it is likely that during the final approach to full employment, private investment may be more than enough to absorb attempted savings, calling for the budget to be in surplus, or possibly, sharply increased interest rates to keep investment in line with available savings out of an income growing at a rate that is feasible in terms of the ability of the economy to adjust to rapid change.

Hitting the Full Employment Ceiling Without Falling Away

As the full employment ceiling is approached, however, a sharp change occurs in that growth at eight to twelve percent is no longer possible, and must be limited to the two to four percent or so attainable with the growth in the population and labor force together with the increase in productivity from innovation and possible increased capital intensity. This means a sharp drop in the potential for investment, at least for investment of the "widening" variety in which more of the same type of equipment is installed to produce a larger volume of output, as contrasted with "deepening investment" to introduce new labor-saving technology.

The situation is complicated by the fact that much new technology nowadays is "capital saving" in that $100 of new capital can perform the work of $300 or $500 worth of old capital: prime examples are the computer industry and communications technology. Telephone companies are stuck with excess windowless space in central exchange buildings because electronic exchanges occupy a fraction of the space formerly required by electro-mechanical exchanges of comparable capacity and provide more elaborate service, and fiber-optic cables, which where they can be fully utilized, cost only a fraction of what equivalent copper cables would cost. In the face of the high rates of obsolescence in such areas, rates of interest are of little significance in determining investment policy. Also, better communication has enabled railroads to abandon much excess main line tracking while increasing traffic flows. The Japanese "just-in-time" method of operation has reduced investment in inventory.

On the savings side, high interest rates may reduce saving rather than inducing increased savings, if they reduce the cost of providing an adequate retirement annuity. In the face of such developments the likelihood of finding sufficient profitable investment opportunities to absorb attempted savings in addition to the funds abstracted from the income stream through depreciation and obsolescence allowances is greatly diminished. There can be no guarantee that there is any feasible rate of interest that will bring the amount that entrepreneurs want to invest in net new capital, in excess of replacements and depreciation allowances, into balance with the amounts that individuals want to save out of a full employment level of income, let alone create a surplus of investment needed to recycle a government surplus with which the government debt is being reduced. It will be up to the government to fill the gap with surpluses or deficits, whichever turns out to be called for. Insistence on a balanced budget, even in the long run, is a recipe for disaster.

At worst, a full employment policy might call for a public debt that increases indefinitely, but remains reasonable in relation to an increasing national income. Servicing such a debt out of tax revenues derived from a full-employment level of income, with fewer demands on the budget for unemployment compensation, welfare, and the justice system, would in all likelihood prove less burdensome than servicing a much smaller debt from the smaller revenue base out of a budget burdened with relief payments. An immediate increase in the debt in the immediate future may be the best way to minimize the burden of the debt over the long run.

Making the Most of Real Resources Rather Than Conforming to Financial Rectitude

This then is the goal I lay before you. Real full employment, at levels higher than have been experienced in peace-time over at least the last century, is to be reached within two or three years and maintained thereafter, with magnificent results not only in increased output and income, but reduced poverty, ill-health, drug abuse, crime, and commitment to the maintenance of a useless military superfluity. But to do this we have to toss out our shibboleths of budget balancing, puritanical abstinence, maintaining the value of the almighty dollar and servicing a "favorable" balance of trade, and instead focus our attention on the real resources, human and material, that we have on hand and figure out how to use them effectively to produce real welfare. Perhaps the markup warrants scheme would not do the trick, but if not, it is up to the economics profession to work out something that will.

A noted economist that I cannot at the moment identify with certainly once remarked that it is the job of public finance to see to it that nothing is done merely for financial reasons. For too long we have unquestioningly allowed numbers on books of account to control our lives. Such accounts have their place, but when they are allowed to compel us to tolerate the wastage of human resources and all the concomitant social problems that unemployment provokes, we must look at the "real" side of the coin. William Jennings Bryan used to conclude his stock campaign oration with "you shall not crucify mankind upon a cross of gold." Today we might say "we must stop shooting ourselves in the foot with a blunderbuss of financial rectitude."

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