1978

Economist’s Comments on H.R. 8333 and S. 1860 (The Kemp-Roth Bills)

Allan H. Meltzer
Carnegie Mellon University, am05@andrew.cmu.edu

Follow this and additional works at: http://repository.cmu.edu/tepper
Part of the Economic Policy Commons, and the Industrial Organization Commons
economy, revenues would definitely be less than if the bill were not passed. The primary case for Kemp-Roth is a growing conviction that Government has been allocating too much of the national income to itself, and that the time has come to change this.

If I were a Member of the Congress confronting a vote on the Kemp-Roth bill, therefore, I would vote in the affirmative.

Allan H. Meltzer, professor, Carnegie-Mellon University

Five points seem to be critical for judging the economic effects. The principal merits of the Kemp-Roth bill are the effects on incentives; the principal problems arise from the effects on the deficit.

First, a main effect of the Kemp-Roth bill is to restore to households and business the additional tax revenue generated by inflation. The merits of this step, I believe, are clear, and make a strong case for the bill.

Second, an additional merit is that tax rates will be lowered permanently by a phased reduction over a 3-year period, that is greater than the currently anticipated rate of inflation, so there will be real reduction in tax rates and reduced uncertainty about the size and timing of taxes applicable to income earned in the future. The reduction in uncertainty and increase in expected aftertax income provide greater incentive to work, save, and invest. I believe the increases in real income that will be generated arise principally from these effects on incentives, since the economy is now close to full use of effective capacity.

Third, the tax cut does nothing directly to lower longrun tax rates. These rates depend on the amount of Government spending and on its rate of growth. The effectiveness of the Kemp-Roth bill would be enhanced by a believable ceiling on the growth of Government outlays that held the growth of Government outlays below the growth of private output. A ceiling of this kind is not envisioned in your estimates of outlays. The attractiveness of the bill would be increased by a ceiling on outlays and the rate of growth of outlays.

Fourth, the Kemp-Roth bill increases the size of the budget deficit for several years in the future. I do not believe there is evidence to support the conjecture that Government revenues will rise enough to lower the budget deficit, and I am skeptical about the prospect of anyone producing evidence of this kind. The importance of the budget deficit arises because the additional deficit resulting from the tax cut must be financed by issuing additional bonds or money. The amount of additional financing will be reduced most effectively if the growth of Government outlays is reduced.

Fifth, the tax cut will contribute to substantially higher inflation if the additional deficit is financed by issuing money. The better alternative is to allow interest rates to rise enough to finance all the additional deficit from sales of debt to domestic and foreign purchasers.

If steps are taken to assure that the financing the deficit does not accelerate money and increase the rate of inflation, I believe a tax cut of the type proposed in the Kemp-Roth bill is desirable. The desirability of the tax cut increases further if the tax can be be accompanied by a meaningful ceiling on the growth of outlays.
The massive tax cut proposed by Senator William V. Roth and Representative Jack F. Kemp represents an irresponsible piece of legislation. The authors of the bill argue that substantial reductions in both the corporate and personal income tax rates, phased in over the next 3 years, will so sharply increase incentives to work and invest that national output will rise dramatically and, as a result, the tax base and Government revenues will increase to compensate for the rate cuts.

The revenue response to the proposed cuts is extremely important since the bill includes no provisions for limiting Government spending. If the additional revenues failed to materialize, the result would be extremely large Federal deficits which could overheat the economy and contribute to an enormous acceleration of inflation.

The sanguine view of supporters of the Kemp-Roth proposal that massive additional Federal revenues would be generated by the rate reductions is based on the so-called Laffer curve. Arthur Laffer has continually argued that current high levels of taxation inhibit work, innovation, and investment. Unfortunately, Laffer has generated no statistical evidence to support his theory nor is there any empirical work suggesting that large reductions in the level of taxation would spur economic activity in line with the projections incorporated in the Kemp-Roth plan.

In short, the Kemp-Roth proposal would probably increase the Federal deficit by $21 billion in fiscal 1979 and by as much as $165 billion in 1983 (see Joint Committee on Taxation, Doc. 784375). Without comparable spending cuts, the resulting fiscal policy would be inappropriate and potentially disastrous for the U.S. economy.

Richard A. Musgrave, professor, Department of Economics, Harvard University

I do not operate an econometric model and therefore am not in a position to make a specific prediction as to what would happen if three successive tax cuts of about $25 billion each were to be made over the next 3 years. I would, however, offer these general comments:

1. I cannot evaluate the bill without specifying what should be done on the expenditure side. If expenditures are to be left unaffected, it seems clear that the proposed reductions will be highly inflationary. If there are to be commensurate expenditure cuts, then they should be specified. Leaving aside whether such cuts would be feasible or desirable, I merely note that they would have to be made to render the bill a noninflationary proposal.

2. Congressman Kemp's repeated references to the Kennedy tax cut of 1964 as prototype for his proposal are misleading. Obviously, the slack in the economy at that time was much greater than it is now and the inflation momentum was much less. Thus, what was a desirable measure to raise aggregate demand and to increase employment in the mid-1960's, would now be an ill-advised inflationary policy. The current problem is not to make up for a massive deficiency in aggregate demand. It is how to deal with stagflation.