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Financial Policies and Business Activity

by Professor Fritz Neumark, Frankfurt-on-Main

In former times, when discussing at all the connections existing between public finances and business activity, interest was focussed exclusively on one of the two aspects of such interdependence between these phenomena, viz. the effect which the cyclical movements of the economy, especially depressions, have on public revenues and expenditure. As late as during the worldwide slump of the thirties, the prevailing belief was that the budget deficits caused by the decline of tax income of the government directly due to shrinking economic activities and the rising outgoings on account of mass unemployment would have to be gradually wiped out by cuts in spending and/or by an upward adjustment of the rates of taxation, lest runaway inflation becomes inevitable.

Recent Enlightenment

Except for some forerunners, e.g. Lautenbach and Colm, it was not before the advent of the Keynesian revolution when—certainly to a large extent under the psychological impact of disastrous experiences resulting from the budgetary "policy of parallelism" which was practised about 1930-32 —for the first time the other side of the medal of interdependence between budget policies of the government and the trade cycle attracted sufficient attention: the fact that governments can influence economic developments actively. The first discovery in this field which for a long time dominated the scene, was deficit spending of the authorities, as a tool to fight the depression. It took those responsible for economic policies till the forties, and sometimes right into the fifties, to find out that anti-cyclical budgetary policies—which are the exact opposite of the notorious policies of "parallelism"—need not be practised as an economic one-way scheme but may be utilised for fighting both inflationary and deflationary trends.

This new enlightenment gained practical significance only after a number of theoretical findings had become familiar and some of the institutions serving as tools of budgetary policies had undergone a change. Briefly outlined, the following major changes had to take place: in the past, it was generally assumed that only such taxes should be levied which were „cycle-proof", i.e. impervious to the effects of economic depression, whilst nowadays the need is generally taken for granted for taxation with a relatively high built-in flexibility, meaning that no change in tax laws, especially none in tax rates, will be needed to make taxes operate, by a virtual automatism, so that suitable anti-cyclical effects of higher or lower revenue yield, as the case may require, will be produced. Likewise, it is no longer thought to be strictly desirable for taxation law to be as unchangeable as possible—on the contrary, active flexibility is now required of all taxation policies, so that they may be used for peakshaving during maximum fluctuations of the trade cycle. By the same token, balancing government budgets precisely, formerly the ideal of every ministry of finance, has now been pushed from its throne, and according to the turn the trade cycle is just taking at the time of budget estimating, a budget surplus or a deficit may be aimed at. Last but not least comes the aim of economic stability, especially a reasonable degree of monetary stability, which is officially assessed as of equal importance with the competing aims of full employment and satisfactory economic growth, but which actually, whenever objectives get into serious rivalry, is being placed second or even only third in the order of priorities. This is a political decision, and this kind of decision about priorities is probably the true reason—apart from the fact that much more ample facilities are now available than were in the past—why for almost four decades now none of the economically advanced countries has ever suffered from a real economic depression. The most they can complain about are so-called recessions. In other words: the former trade cycle of alternating boom and slump has been replaced by a new type of growth cycle. Admittedly, growth rates are still subject to considerable fluctuations, but they do not turn any longer into complete reversal yet

may, as an extreme case, tend towards marking time for a brief period. As a reflection of this, rates of unemployment of 20 p.c. or more, as they were registered in the US and in Germany in 1932 and thereabouts, seem to be a thing of the past for good.

Achievements of the Past Insufficient

Though this has been ample progress from the points of view of the economy, of policy, and of social justice, it is only to be welcomed that nobody wants to rest on his laurels. The overall aim to be reached, last but not least, by way of fiscal policies (which, however, must be in agreement with the adopted monetary policy), is a high and practically completely steady degree of employment, and a level of economic growth which is accepted as satisfactory, coupled with reasonable stability of the purchasing power of money. In other words, the various aims of the economic policy of an enlightened government agree in the endeavour to minimise the fluctuations of the three described variables which will be fundamentally inevitable in any dynamic economy. In which way is it possible to approach these aims through the workings of fiscal policy?

In the first instance, as has been indicated, it will be imperative for any government to use its budget for anti-cyclical purposes, which may be achieved by varying expenditure, taxation, or borrowing. Apart from the specific effects of individual measures, stabilisation will be effectively promoted by budgetary surpluses, which may accrue automatically during a boom threatening monetary stability, and which can be increased by deliberate action, being withdrawn from circulation. This means that these amounts must be "sterilised" through accumulating credit balances with the central bank. Conversely, during periods of recession, budgetary deficits must be taken into account or even be increased on purpose, i.e. the government must finance more of its expenditure from short-term credits than originally intended.

Budget surpluses and budget deficits of a predetermined size may be produced either by taxation or by deliberate spending, or by a combination of both. What is to be preferred as the best way of operation cannot be easily stated, but the pros and cons of different approaches may be discussed.

Control through Government Spending

Up to a point, certain expenditure has an automatic stabilising effect, by tending to expand in times of recession, and to decline during booms, without its basis in law being changed, and thus has the desired anti-cyclical effect pro rata of its incidence. A prominent type of such expenditure are unemployment benefits and related supplementary allowances. However, if it should remain true that, in future, no mass unemployment will be permitted to develop, even not in the short term, only minute stabilising effects can be expected of fluctuations in the size of the dole. As a matter of fact, most developed countries have in recent years recorded unemployment rates varying between 1 and 5 p.c. only, and the Federal Republic of Germany can justly claim to have changed only from full employment to over-employment and back for the last ten years, not having experienced any real unemployment any longer.

This is the reason why deliberate variations in spending have been playing a much more prominent part in the present situation than more or less automatic regulators. However, there is still great unevenness in the application of such economic tools: people have theoretically agreed that it would be unreasonable, from the point of view of stability and economic growth to use government revenue, which expands inevitably in boom periods, for financing extraordinary government investment—the type of expenditure which is ideally suited for such planned variations—beyond projected estimates in a boom situation, but it proves to be politically difficult to make unpopular cuts in reducing the relative size of such spending. Similarly, though governments are, in principle, willing to spend more during recessions, they find that there is a lack of projects which can be started without delay, for technological reasons. The best intentions can often not be carried out with due speed, and it may be seen frequently that it is only the Federal Government, which shows ability to press forward in the correct, anti-cyclical direction, whilst provincial and/or local authorities have the ingrained habit to conclude from stagnating or declining revenue that they must also reduce, even in absolute terms, their investment projects.

Improved Tools in the Federal Republic

The German Act for Improving Economic Stability and Economic Growth (Stability Act) of June 8, 1967, and the financial reforms introduced during 1969, which mainly reorganised intergovernmental fiscal relations between federal and provincial authorities, have forged much improved tools for influencing the trade cycle. The Federal Government has thus been authorised to spend up to DM 5,000 mn over and above the normal budget on the basis of short-term credits (or from

the "Trade Cycle Equalisation Fund", which will be discussed later), when a recession threatens or has already begun. In this context, it is of major importance that the new law permits only the financing of new expenditure of a kind in this way as has been earmarked for such purposes in the Medium-Term Finance Plan—namely investments, and not spending for „social consumption". Another set of measures has been introduced for freeing local government authorities from the necessity to cut their investment programmes as soon as economic growth marks time: on the one hand, local government income now flows increasingly from sources which are not as strongly dependent on the economic cycle as is the Business Tax, from which 80 p.c. of all local government revenue flowed until recently; and on the other hand, the Federal Government has now been authorised to help the local authorities financially with special types of investment. In practice, in spite of the rules laid down by the Stability Act, it will probably be more difficult (as it always was) to enforce the required relative reduction of public sector investments in periods of rising inflation. I deliberately speak of "relative" reductions, because it goes without saying that even in boom periods, I believe that it will not be politically feasible, nor even economically desirable, to reduce the actual volume of government spending. But it is certainly possible to dampen down deliberately public financing of new projects to such an extent that during periods of inflationary pressure the growth rate of government spending will stay not only below that of the Gross National Product (GNP), but also below that of government revenue. If it should be possible to restrict such caution in spending to the treatment of government expenditure for purposes of consumption and leave investments more or less unscathed, this would be particularly useful from the long-term point of view. What really happens—and has happened —in many countries, however, is a rather different story, for example (one of many instances), in the United States. The GNP of the US, in nominal prices, rose about 9 p.c. during 1968. Because of the erosion of the dollar's value, this was only about 4.5 p.c. in real terms. But Federal expenditure alone, not counting defence spending, grew by about 15 p.c. in nominal prices, and total Federal outgoings by 11 p.c. What has happened in this respect in Germany during the two latest boom years of 1968 and 1969 is not yet known with sufficient precision, but apparently the general trend has not been more encouraging than the American experience. Nonetheless, it is noteworthy that a decree issued on July 24, 1969, strengthened the „Trade Cycle Equalisation Fund" by an amount of DM 3,600 mn from additional revenue, though the government was at the same time authorised to make this transaction partly a purely nominal one by writing over to this fund the equivalent of certain acts of debt redemption.

Tax Policy for Maintaining Financial Equilibrium

To a much greater extent than was believed to be either possible or desirable in earlier periods, governments now use taxation to steer a course of sometimes anti-inflationary, sometimes anti-deflationary fiscal policy. One of the reasons for using this method is that, in order to maintain an economy in which the freedom of the market is to be preserved, government prefers to reduce taxes during recessions, to raising public spending. The preference for using changes in taxation to influence the business cycle is also, at least in part, the outcome of the fact that taxes claim a much higher share in the GNP today than they used to do only a generation earlier. In the Federal Republic of Germany, for example, total tax revenue of all political levels, for the last ten years, has claimed a fairly stable share of 23 to 24 p.c. of the GNP, which is about double the percentage taxed away before the First World War. By adding social security contributions (which, however, are not amenable to chopping and changing their rates in the service of an anti-cyclical policy), the share is increased to about 34 p.c. in Germany, to no less than over 38 p.c. in France and Sweden, but only 28 p.c. in the United States.

There are two main forms of using taxation for putting the brake on exaggerated fluctuations of economic growth—a passive one using "built-in flexibility", and an active one, using deliberate decisions on flexibility. Built-in flexibility is a kind of automatic stabiliser, but it would be deceptive to believe that only deliberate, individual decisions about varying the burden of taxation can become the vehicle of carefully planned campaigns of government and parliament for launching an anti-cyclical financial policy. On the contrary, for creating built-in flexibility, it is also necessary at first to make policy decisions about the structure of taxation and about the techniques of assessing and collecting individual taxes, but to a certain extent refunds of public debts could be taken into account as equivalent to this revenue earmarking. Once these decisions have been made, however, the business cycle will be influenced by taxation and its yields, which change in a direction opposite to that of the cyclical fluctuations, without the authorities having to worry about the need for ad hoc changes of tax rates, personal and other allowances, and tax-free basic amounts.

What is the meaning of the term „built-in flexibility"? In the case of taxation, it means that the yield of certain taxes will change in proportion to fluctuations of the GNP. The ratio of tax yield to GNP will be dependent on a number of variables, among which the relative importance of the given tax for the total of fiscal revenue, and the sensibility of the tax basis to changes in the business cycle and in the rate of economic growth, are crucial. Of course, the degree to which the levying of a given tax is progressive also plays its important part, because progression may increase "passive" tax flexibility in the sense defined above. But it is not only the proportion in which tax yields change, relative to changes of the GNP, but also the speed with which such automatic adjustments operate which is highly important for the effectiveness of a tax as an economic stabiliser. Speed of operation will be influenced by: the object of a given tax or the basis for computing tax liability, and the method of tax collection. The German so-called wage tax (income tax on earned income from dependent employment), which is withheld at the source (similar to British PAYE), is therefore ideally suited to inducing prompt reaction to this type of tax which is highly sensitive to all changes in the business cycle. On the other hand, the delayed collection of German "assessed" income and corporation taxes (analogous to British income tax payable by self-employed persons), with its late incidence, makes these taxes payable only long after the developments they reflect, and their effect may therefore not be anti-cyclical but exaggerate the fluctuations by which they are caused.

Most western industrialised countries operate tax systems which have changed over quite some time ago to a high and rising share of revenue derived from taxes which are strongly sensitive to business fluctuations. The trend towards such a system would have been even stronger, had not governments and parliaments reduced, from time to time, by discretionary decisions, especially income tax rates and/or increased personal allowances and other tax-free basic amounts. Present-day taxation in the Federal Republic of Germany consists to about one half of taxes with very strong built-in flexibility, viz. Income Taxes and Corporation Taxes (together about 40 p.c. of total revenue) and Business Tax (about 10 p.c.), when one analyses overall taxation yields for all political levels. It is true that also motor vehicle taxes and excise duties on mineral oils are highly sensitive to cyclical fluctuations, but these taxes are to a large extent earmarked for special purposes, feeding in the first instance the funds for road construction. In the United States, it is likely that the built-in flexibility at least of the Federal tax system is more strongly pronounced than in Germany. Very recently, it has actually been criticised for being too much so, thus creating a "fiscal drag" and therefore endangering economic growth, especially because of the steep progression of Federal income tax. This had caused Congress to vote for drastic tax cuts in 1964, and it is intended to introduce further reductions in 1970.

Discretionary Tax Adjustments

Such tax cuts lead over to the field of tax adjustments made ad hoc by the levying authorities, parliament and/or governments. These measures are the instruments of active tax flexibility—deliberately adopted tax changes, resulting in changes of tax yields. The direction of such changes usually is adapted to the movements of the trade cycle, but has an anti-cyclical purpose and effect. In practice, this means that during boom periods and inflation, taxation rates will be increased, and the resulting additional revenue will be "sterilised", i.e. accumulated and not spent. During recessions, the rates of the same taxes will be reduced, without declining revenue causing reduced government spending. When using such measures, it is again of decisive importance that the taxes so varied for purposes of influencing the trade cycle must be taxes with a sufficiently broad field of application, the changes of whose rates have also a speedy effect. Sufficient width of application and speed of impact, in our age, can essentially be ascribed only to income taxes and general turnover taxes, especially taxes on net value added. In addition to the choice of such tax types for discretionary variation, some additional conditions must be met for making active flexibility effective: the trend of the economic development must be correctly diagnosed and forecast, and the necessary anti-cyclical tax adjustments must be made in time and applied without delay. Leaving aside here the difficult problem of how to arrive at correct diagnoses and forecasts, there is a twofold task to be solved—which kinds of taxes are best suited for making active flexibility operate through discretionary adjustments, and how to achieve promptness in deliberation and execution of tax adjustment measures for anti-inflationary or anti-deflationary purposes, which have been found necessary.

The first part of this problem has been the subject of prolonged discussions but both finance theory and practical considerations have now come to the conclusion that mostly income and corporation taxes are suited best for operating

an actively flexible taxation policy. Only the United Kingdom is an exception from this rule still being observed, as the Chancellor of the Exchequer has had authority for years now to use purchase tax and excise duties as economic "regulators" through varying their rates. Chancellors have repeatedly used this authority.

The Special Case of the Federal Republic

On the other hand, the Federal Republic of Germany is at present the only country where, through the Stability Act, the government has power to use decrees for changing the rates of income and corporation taxes, but only under certain conditions. One of these is that either recession or inflation must be already noticeable or safely predictable. Secondly, only "linear" (straight increases or decreases) of tax rates may be imposed for not more than one year for which a ceiling of 10 p.c. of the basic tax rates has been set. The two chambers of parliament—Bundestag and Bundesrat—must both agree to such decrees; in case they don't, they are only allowed to pronounce a flat rejection, but they cannot amend the decrees. If, in the case of an overheated boom, the tax rates are raised, the increased revenue must be immobilised by adding it to the Trade Cycle Equalisation Fund. If such increases were in force at the present time, their extra yield would be between DM 5,000 and 6,000 mn p.a. Additional trade cycle equalisation funds may be (but need not be) formed out of increased government revenue flowing from taxes with built-in flexibility, so that it is clear that Federal German finance ministers have ample instruments at their disposal for dampening down effectively extreme fluctuations of the trade cycle with their adverse influences on employment, the value of money, and economic growth. This has been the main object of building and stocking such an armoury. It may be highly desirable to have tax laws which are not subject to frequent alternations but much more important is steady economic growth for whose maintenance appropriate tax changes may be necessary.

In a democracy, the slow path of legislation is much too laborious for escape from a dilemma between two opposing aims, as it is easy to understand that no parliament will grant a government unlimited authority to introduce or abolish taxes, since modern parliaments have grown up in the struggle for "granting supplies" to absolute monarchs. Congress in the USA has to this day refused the President even stand-by authority for introducing limited tax amendments for purposes of influencing the business cycle. The method adopted by Germany, on the one hand, secures to parliament protection against one-sided executive action which may not be approved by the assembly, as the government's tax decrees are subject to its approval; on the other hand, decreed tax adjustments made ad hoc have been limited so strictly by size and in timing that it may well be assumed that parliamentary approval of a simple measure containing a single paragraph only will usually not be refused but be granted speedily.

Need for Fiscal Harmonisation

Federally organised states, e.g. Switzerland, the USA, and the Federal Republic of Germany, have had the experience that anti-cyclical budgetary and fiscal policies introduced by the federal government will lose their full intended impact unless provinces and local government authorities can be persuaded to follow suit in their fiscal policies, so as not enlarge the amplitude of trade cycle fluctuations. Unless there is an enforceable law to secure such an agreement, there is no way of forcing provincial and/or local authorities into compliance in a federally-constituted state. Therefore, not infrequently the authorities on the different levels of government have behaved in quite a different way, some in anti-cyclical fashion, others following the current trend of business developments. Germany has now the statutory instruments, among them the Stability Act and some recent amendments to the constitution, which enforce the obligation on provinces and local bodies to operate fiscal policies similar to those of the Federal Government. Fiscal harmonisation of this kind places the duty on all public authority, federal, regional, or local, to serve the equilibrium of the national economy, and only in this way is it possible to secure sufficient effectiveness of taxation and spending policies for influencing the business cycle.

To conclude, it must be emphasised that budgetary and financial policies have come to grow into indispensable tools for dampening down the extremes of growth and employment fluctuations and for establishing and/or preserving a stable purchasing power of money, but that these tools, by themselves, are not sufficient for the purpose. Support is needed especially through coordination and cooperation with the authorities responsible for monetary policy. And to be candid and realistic, it must be admitted that it appears much easier, in our time, to fight recessions through fiscal measures than to staunch inflation in a similar way.