Discussion Club March 19, 2014 Presentation by Max Gillman

Thank you very much for having me before this distinguished group. I especially thank Harry Langenberg, Dave Rose and William Rogers for this honor. My talk involves some monetary theory, history, and policy with a neoclassic economic perspective that monetary policy is a part of fiscal policy. Rather than a Federal Reserve system acting independent of the government, I will develop a sense in which a unified budget including the Fed may actually be an optimal way to conduct monetary policy.

My talk is a-political. In caution, it is without rabble raising . Without flag waving. And without populist anthems. However I will talk about God.

Last month we heard from Christopher DeMuth about how the debt is high, bad, and not so hard to fix if we just let the do-ers do and the talkers talk. My view is less sanguine. I also think key policy issues can be resolved. But I would never call it easy to do as it might appear from a policy think tank perspective. Rather it may only be possible if the proposal achieves a certain, in the concepts of Adam Smith's third Treatise called Lectures on Jurisprudence, political equilibrium similar to an economic equilibrium by which markets clear.

My personal perspective is formed from seeing the close interaction between proper budgetary processes and good reform of taxes. For this I will use first my experience working as a legislative aide to Congressman Bill Gradison, a Republican from Cincinnati, in the Reagan era early 1980s. I will also use my entire academic career that has followed certain taxation issues.

Consider that in the US Constitution, The Origination Clause, also known as the Revenue Clause, is as follows:

"All Bills for raising Revenue shall originate in the House of Representatives; but the Senate may propose or concur with Amendments as on other Bills."

This was part of the Great Compromise that was key in selling the Constitution's Ratification. During debate on its passage, in the Federalist Papers (58), James Madison wrote "The house of representatives can not only refuse, but they alone can propose the supplies requisite for the support of government. They in a word hold the purse."

Bill Gradison served on the House Ways and Means Committee to which all tax bills are referred according to House Rules. This was the era when Dan Rostenkowski was Democratic chair of the Committee, Barber Conable was ranking Minority member of the committee, and the quite knowledgable former head of the committee, Wilbur Mills, was reduced to lobbying Bill Gradison after leaving Congress.

Gradison is a PhD in Business from Harvard with an Economics specialization. He championed the idea of income tax bracket indexing to inflation. This was important during this high inflation period because only when this bracket-indexing was introduced into the Conable-Hance substitute Ways and Means Committee bill at the last hour was Reagan's 1981 tax reduction able to pass Congress.

After that I arrived and as Ways and Means legislative assistant for Bill, we did several other tax initiatives. Bill knew the value of these from his career and I knew the value of these from taking Arnold Harberger's public finance class: (don't undervalue the kick from a good education). One of Harberger's ideas was that the

Investment Tax Credit of 10% from Kennedy's era was economically inefficient. It biased investment towards shorter term horizons away from longer term horizons. I inferred that it should be eliminated with the revenue gained to be used to lower the corporate tax rate in a revenue neutral fashion that increased the incentive to invest.

1. However there were some serious practical problems to further tax reform that we ran up against immediately. Most of all was that the tax base itself was poorly defined because of uncontrolled growth in fringe benefits. Fringe benefits can be part of statutory law, like the one for Health care, or they can be determined by IRS regulation. Unfortunately, every time the IRS issued a regulation a group would complain to Congress and Congress reacted by prohibiting the IRS from issuing regulations clarifying what constituted a fringe benefit. They continued this prohibition every two years for some 10 years at that point. This allowed fringe benefits to grow without constraint.

Therefore in order to work on some good tax reform, it required clearing up the issue of how to determine fringe benefits. Economics to the rescue again. I drafted up a white paper for the Ways and Means Committee members and staff that showed how each of 40 different fringe benefits could be defined relative to the marginal cost that the benefit incurred. For example, the 20% discount that employees might get at a clothing store like Federated might be reasonable because the employees did not use the marketing and advertising costs since they already knew about the stock. The cost to Federated of employee bought clothes was less than the retail cost. So this gave a range for a reasonable discount that was non-taxable as income, and so a non-taxed fringe benefit. Staff then worked up this Marginal Cost foundation into a bill that Gradison introduced and it eventually became the little known Tax Reform Act of 1984.

2. With the tax base now cleaned up, it was easier to turn to tax reform. Bill Gradison liked the idea of eliminating the 10% Investment Tax Credit (ITC) and using the revenue gained to reduce the corporate tax rate, which was then at 46%. He let me meet with and implore the staff of the Joint Committee on Taxation to determine by how much we could reduce the corporate tax rate if we eliminated the ITC. After some considerable months of bugging them, they produced a number: we could lower the corporate tax rate by 7 points from 46 to 39% from this one provision alone.

Bill then instructed me to prepare a letter explaining this for Reagan's then new Bipartisan Commission on tax reform that was headed by Treasury Secretary Donald Regan. By eliminating in addition a clutch of other lesser tax credits and subsidies, it was determined that the corporate tax rate could be reduced to 33%. This was accepted by Bob Dole as head of the Senate Finance committee, and by the President and Congress and this became the Tax Reform act of 1986. Corporate tax rates have never been reduced again since then, with Clinton actually raising them back up by 2%. And that is where we are today, one of the highest corporate tax rate among developed countries.

3. Now let me switch gears to a budgeting-plus-tax-reform issue in the Social Security Reform act of 1983, the last time that the Old Age and Survivors trust fund was reformed. Before this act, the social security trust funds were on the unified budget of the US. This had only come about in 1969 because President Johnson wanted to hide the US Treasury deficit from the Vietnam War with the Baby-boom Trust Fund surpluses that were accumulating at the time off-budget. Off-budget is in a sense better for these trust funds

since they cannot be used to finance the general Treasury budget, nor can the Treasury finance these funds with general revenues: only the payroll taxes can finance trust fund expenditure. So the trust funds were on-budget and needed reform because in 1981 they were going broke relative to spending. Bob Dole had made the mistake of proposing Social Security benefit cutbacks before Reagan's first midterm election and it was said this led to the Republicans losing 24 seats in the House. So Gradison proposed as part of the reform that we take Social Security back off-budget so the reform could be done outside of the political tinderbox of the general Treasury deficit. This was adopted by Reagan Bipartisan Commission on Social Security headed by Alan Greenspan, and it became law in the 1983 Act, along with various tax and benefit changes that refinanced the system supposedly until around 2017, which looks today to be about right.

Therefore in both tax and spending reform, getting the tax base "budget" for tax revenues well defined, and getting the budget for spending funds well-defined, became key to successfully reforming both broad tax rates and our social welfare system.

Second, in terms of my experience upon which I will draw this evening, I will now use my mainly academic experience about the history of monetary economics and what economists call the inflation tax. Naturally, one would think that all taxes must originate from the Ways and Means Committee in the US House of Representatives. Yet we also know that Volcker, Greenspan, and Bernanke have been called the most powerful men in the US, or in short Gods. If you dont believe in this type of God, you need to ask yourself the following question: Why are they treated like Gods?

My answer is not religious. It is that the Chairmen of the Board of Governors of the Federal Reserve System largely determine by themselves the level of the inflation tax. No single individual in Congress can make such a claim for any tax, yet the Chairman of the Fed can. Again: Why?

The Fed was established in 1913 when the US was on a gold standard that kept the price of gold set at $20.67 per ounce of gold, at which price one could exchange government currency for government owned gold. While there were breakdowns shortly thereafter in the gold standard during WWI, and again in WWII, the US remained largely on a gold standard after WWII. At that time the Bretton Woods Treaty of 1946 reestablished a US led gold standard whereby the US kept the price of gold at $35 an ounce.

While I am not an expert on the gold standard, I am currently conducting research on the relation between gold and "fiat" currency. Fiat currency is unbacked by gold: it cannot be traded in for gold. This pure Fiat currency is what the US established in 1971-1973 when Nixon ended the Bretton Woods agreement and the US left entirely the gold standard. What this means is that it is only after 1973 that the Fed could increase the money supply to any degree it wanted, or say, the Treasury needed. And it was only then that the Fed chairmen became Gods.

Now it is not a coincidence that as Bretton Woods was breaking down that President Johnson put Social Security on-budget in 1969. Both were the result of the US running a large deficit from financing the Vietnam War and printing money to pay for this deficit. Before Bretton Woods broke down the other signatures to the Treaty had to soak up our excess dollars by printing their own money to buy our dollars. This exported the US inflation to other countries, while the US kept the price of gold at $35 an ounce, until finally Nixon gave up the sham (remember his price controls, also used in WWII) and inflation in the US was allowed to rise unfettered with growth in the US money supply.

The 1970s until 1981 was our largest historical inflation experience post WWII. The other two periods were WWI and WWII. The Fed was conveniently created just before WWI when it subsequently printed a lot of money to finance the WWI, despite the gold standard; it did the same in WWII; and it did the same in what I am embarrassed to say our macroeconomics principle books call a peacetime period of the Vietnam War in the 1960s and 70s.

Therefore the question of all monetary economists in the pure Fiat era is: What is the best monetary policy that the Fed should follow? Neoclassical monetary economists would put this as: What inflation tax should the Fed levy and how should they do it?

Wicksell, Irving Fisher, Hayek, Milton Friedman and their modern followers all consider that monetary policy was such that printing money caused inflation. They also all have stated that printing money in order to temporarily drive down market interest rates is a very dangerous game that distorts investment and is economically inefficient. Unfortunately Bernanke [now Yellen] does not agree.

In fact, this split amongst prominent economists dates at least from the beginning of modern neoclassical monetary theory, with Irving Fisher's equation of exchange that put the quantity theory of money into mathematical form. John Maynard Keynes at first fully embraced Fisher's quantity theory in his 1923 Tract on Monetary Reform. There he prescribed how to achieve Fisher's proclaimed goal of stabilizing the economy-wide price level, and so inflation: Keynes said this could be done simply by letting money supply follow money demand.

So far so good. But while Fisher stated that the stock market had no reason to decline in 1929, and he subsequently lost his wealth in the Crash, Keynes foresaw the coming of WWII and the crash of the newly won European markets. In his 1922 Revision of the Treaty, he writes that the WWI Treaty of Versailles is "crumbling" because the Central powers who lost WWI cannot pay the Versailles Debts imposed upon them in order to pay for the war damage. He advocated instead what we today would call the Marshall plan, for the losers of WWI. Keynes was correct and Germany spun into a 1920s hyperinflation and the Rise of the Third Reich, and then WWII.

The worldliness of Keynes led people to pay high respect to his famous Treatise on Money in 1930. There Keynes explicitly said to throw away Fisher's theory of the price level as determined by money, and instead he advocated a price theory based on average cost, as in his teacher's treatise; this teacher was Alfred Marshall and his book was the neoclassical foundation of modern Economics: the Principles of Economics, which had 8 editions from 1890 to 1920. In doing this Keynes came up with a brilliant theory of the business cycle, in which printing money or having the government spend money would get nations out of recessions. His analysis was at the basis of his even more famous 1936 General Theory of Employment, Interest and Money.

Unfortunately, unlike Marshall, Keynes defined profit as Investment minus Savings. When positive, the economy expands, and when negative it contracts. So in a contraction the government can spend uninvested savings and force an economic recovery. But the problem here is that profit instead is a random residual in the modern neoclassical economic formulation in mathematics that Keynes's star student Frank Ramsey established in 1928. It is not equal to Investment minus savings and so the whole Keynesian edifice theoretically collapses.

That has not bothered the modern Salt-water economists who like it when economists can have a big say in what the government does, and who are happy to put the financing of expenditure off somewhere in the future. This is opposed to the Fresh-water economists who think that government spending is key for social insurance activity, like Hayek, but that spending needs to be carefully justified and always financed by well-known taxes.

This brings me to my conclusion on how the monetary policy debate can neatly evolve into a dying ember. The Federal Reserve System is an off-budget entity. When they bought a trillion dollars in mortgage securities, instead of Geithner at Treasury buying it, the White House incurred no budget expense that Congress had to approve through the budget process. If Treasury had bought this directly, instead of the Fed, then the budget deficit would have been increased by the estimated expense of this subsidy in the fiscal year during which the mortgages were bought by the Fed.

What has been Unconventional about Fed policy is that it has secretly in plain view for all to see allowed the Executive branch to avoid the Congressional budget process over these asset purchases. Formerly the purchasing of the exact same type of mortgage debt was done by the then-off budget branch of Treasury called the Federal Financing Bank. Gradison and I held a Ways and Means Committee hearing into this skirting-of-the budget practice in the early 1980s and introduced legislation that resulted in putting the FFB on budget as it is to this day. This left the White House to privatize Fannie and Freddie in the early 1980s, with the impact that in the 2008 Crash the Fed became the new way to government-guarantee the debt anyway, once again in an off-budget fashion. It facilitated a huge financial crisis, major recession, and brings the current spectre of rising inflation looming in the future.

Putting the Fed on budget would require Congressional budget approval for all Fed spending. This would not affect any claims to Fed independence unless that claim means unlimited budgets.

This would effectively put the inflation tax into the Congressional budget process for the first time since the advent of the modern Fiat currency. As such, Congress would likely vote to keep the inflation tax low and steady, except with specific approved increases during times of War. As a result, our national economic fiscal policy would include inflation tax policy simultaneously and be done more efficiently with less distortions to markets, not to mention that it would be more consistent with the Spirit of the US Constitution. This Constitution was meant to replace monarchies, who sometimes viewed themselves as Gods. Putting the Fed on-budget would make the only remaining Gods in the US once again reside within each person's own identity.