# Federal Spending and Deficits Must Be Controlled to Stop Inflation

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Inflation is the primary problem that must be solved in order to restore effective functioning of the U. S. economy. It will not be solved until the public understands that inflation is caused by excessive government spending and large Federal deficits.

**The Real Meaning and Cause of Inflation**

Inflation reflects a fall in the purchasing power of money and a corresponding rise in the composite level of prices caused by an excessive expansion in the supply of money and credit. Control of the supply of money and credit is entirely in the hands of the Federal government through the actions of the Treasury and of the Federal Reserve System.

Inflation is caused not by a shortage of labor or goods but by a surplus of money and credit. Such surplus develops whenever government persists in spending much more than it collects in taxes. Such action creates artificial purchasing power to the extent that deficits are financed by government promises to pay in the future rather than by the savings of consumers. In the absence of surplus money, even a large rise in prices of a major class of commodities, such as food, would be offset by declines in other prices, with little change in the value of the currency.

Inflation interferes with normal economic processes by penalizing those who save and rewarding those who incur heavy debts. For example, individuals who bought government bonds during World War II found that the dollars received when the bonds matured bought much less than the dollars invested much earlier. In terms of real purchasing power, lenders experienced a loss instead of a reward for saving. Such experience discourages savings and also makes planning for the future difficult because of great uncertainty as to the value of the dollar in later years.

**Inflation Impedes Economic Progress**

Developments that discourage savings inevitably impair the rate of economic progress. Savings are essential to create the tools and facilities required for more and better jobs. The remarkable economic progress of the U.S. in the past has been based on the increasing amount of capital per worker that made possible an expanding output of goods and services per hour of work. So long as individuals can reap adequate rewards for their work and savings, they can be induced to promote the national economic welfare by their collective efforts.

It is widely recognized that more business investment will be needed to provide adequate employment opportunities. However, government officials do not seem to realize that current rates of inflation are the major obstacle to the necessary rate of expansion in employment, investment, and production required to improve average living standards for a growing population.

The difficulty in expanding real capital investments in business can be illustrated by the experience of the past twelve years. In that period, the average cost of replacing business plants and equipment has doubled according to the government index. Because of that change, a facility built for $1,000,000 in 1966 will cost $2,000,000 to replace in 1978 merely to maintain the same capacity. The depreciation allowed under the tax laws will total only the original cost of $1,000,000. The current investment tax credit of 10% will provide $200,000 of the additional sum needed for replacement. The difference of $800,000 required to maintain the real value and capacity of the original investment has to be raised from revenues incorrectly taxed as income. As a result, the profit required in order to stay in business with the same capacity seems to provide a very high return on the original investment, but the appearance of high profits is false because it results from the lower value of the dollar.

The irony of the situation is that the 10% investment tax credit is called an incentive granted by government to encourage investment. In fact, in the circumstances of the past twelve years an investment tax credit of 50% would be required to avoid taxing as ordinary income some of the revenues needed to maintain the real capital of the business. Business has failed to make this point clear to the public although it should be readily understood by workers who insist that their real income be protected against the decline in value of the dollar.

Inflation also poses serious problems for the average family. If prices continue to increase at the average rate of the past five years, a typical family of four would need an increase in income of 125-150% over the next ten years to maintain the same purchasing power after Federal income and social security taxes. That advance would call for average annual increases in income of 8-9%. If rates of pay rise that rapidly, then the unit labor cost of goods and service will rise by 6-7% per year since productivity of labor is improving only about 2% per year over the course of the business cycle. This situation means that inflation creates a vicious circle that limits opportunity to improve living standards even with large increases in pay earned by hard work. If inflation were to continue at a rate requiring pay increases of 8.5% per year, a worker entering the labor force at age 20 earning $10,000 would have to receive about $390,000 a year upon retirement at age 65 just to maintain the same after-tax purchasing power as at the beginning without any reward for experience or merit.

**Inflation Cannot Continue at a Steady Rate**

Continuation of inflation at high rates over a long period of years would destroy our economy and our political system. If inflation is not checked soon, the inevitable consequence will be a steadily accelerating rise in prices. The final result would be a financial crisis wiping out the savings of the great middle income families that constitute the real strength of a democracy.

The road that the U. S. has been following since 1965 will lead to further drastic devaluation of the dollar. The end result could be to convert existing dollars into a new penny, as De Gaulle did in France after World War II by making 100 old francs equivalent to one new franc with a purchasing power equal to that of the old franc before the war.

It is not necessary, however, to continue following the present road to financial chaos. Experience demonstrates that inflation can be checked by taking decisive actions to control government spending

and to restore the effective functioning of a market economy responsive to the realities of supply and demand.

**Inflation Can Be Stopped**

The U. S. has experienced previous periods of inflation from which it has recovered successfully. The major inflations before this one were caused by heavy spending for military operations during wars which were financed in large part by deficit spending. After the wars stable prices were achieved again when government spending was reduced and deficits were eliminated.

The experience after World War II provides a recent example of how inflation can be brought under control following a period of large deficits. The surplus money created during the war caused a sharp rise in prices when controls were removed in 1946, but the government reduced spending and operated with a surplus of revenue for 1946-51, which permitted reduction of the outstanding public debt. The cost of living stabilized in 1948-50, rose slightly at the time of our military action in Korea, and then stabilized again from 1952 through 1965 during the time that federal spending was kept in line with the real growth of national income. For 1952-65, the average annual increase in the consumer price index was only 1.5%, compared with 5% for 1939-52 and 5.5% for 1965-77. In both periods of inflation government spending increased much faster than the nation's real income and the federal debt rose very rapidly. At these high rates of inflation the purchasing power of the dollar dropped 50% in 12 to 15 years. By contrast, at 1.5% increase per year the same decline would take nearly 50 years.

The long term growth in the real national income of 3-4% reflects the combination of an increasing labor force and improved productivity made possible by greater investment per worker in better machines and tools. Whenever spending by government jumps sharply above that rate, the strong resistance of voters to sharply increased taxes leads to the deficit spending responsible for surplus money and a rapid rise in prices.

Federal spending has increased at a rate of 11% per year since 1965 and is scheduled to increase at the same rate through 1979. Revenue has fallen short of expenditures by a steadily widening margin. As a result, the federal debt increased as much between 1966 and 1976 as between 1936 and 1946. Inflation now is likely to be worse than after World War II because there was much less unused labor and productive capacity in 1966 than in 1936.

The lessons of the past are very clear as to the conditions required to achieve and maintain stable prices. First, government spending must be restrained to increase no faster than the long term growth in real national income of 3-4%. Second, federal deficits must be eliminated over the normal business cycle of four years, with deficits during a recession limited to the surplus accumulated during the preceding years of high economic activity. Third, the Federal Reserve System must follow policies that keep the supply of money and credit in line with the long term economic growth rate.

**Government Spending Must Be Checked**

The basis of inflation since 1965 has been an excessive increase in spending by all levels of government that has been completely out of line with the growth of only 1% a year in population and 3% a year in real national income. Inflation cannot be stopped until government spending is checked sharply for a number of years in order that the burden of taxes and public debt can be reduced back to reasonable levels similar to those of 1952-65 when prices were relatively stable.

Efforts to control spending must be made at all levels of government. We should start by impressing on local and state officials the need to keep spending in line with the real growth of income. The total cost of all local spending, including federal grants, must be taken into account in order to avoid extravagant outlays. The danger in federal sharing in the cost of local projects is that people will be deluded into believing that federal money does not cost them anything. In fact, the federal government must finally pay through taxes and inflation for everything that it spends. Any community with income at or above the national average should realize that what it spends in federal money will have to be paid for in full by its citizens plus all of the administrative costs of collecting and redistributing the funds through the U. S. Treasury.

The major step to check inflation will be to regain control of federal spending. Unfortunately, there are many pressures on congressmen to seek federal funds to take care of local needs that could be handled more efficiently and economically by local governments. The trouble with federal revenue sharing programs is that, as mentioned, they lead to extravagant outlays which would not be made if people realized that they finally have to pay for all the cost locally. If local governments have the support of taxpayers to shift some of the burden from property and sales taxes to income taxes that can be collected most efficiently by the federal government, the best economic solution would be to provide that a specified portion of income tax collections from each county or metropolitan area be returned to the appropriate local governments to be spent in accordance with the wishes of local voters rather than subject to the control of the Washington bureaucracy.

It seems clear that the majority of voters would like to see government spending checked and inflation stopped, but it will not be easy to bring these results about under our present system in which we vote on candidates rather than on issues. Unfortunately, there is little resemblance between what candidates promise while campaigning and what they do if elected. Perhaps what we need most is a law requiring truth in political campaigns, with the penalty of removal from office as soon as any campaign promise is violated.

Voters must find a way to reassert their control over the burden of taxes and the amount of public debt. Since the federal government relies so heavily on income taxes, the most important step will be to see that inflation does not automatically increase the burden on taxpayers for the benefit of the Treasury. The basic assumption in support of graduated income tax rates is that ability to pay taxes increases with income, but that assumption is not valid if the higher income is caused by the decline in the purchasing power of the dollar. Therefore, the tax laws must be changed to provide for automatic adjustments annually in all income tax brackets in relation to the change in the value of the dollar. Furthermore, deductions allowed in computing depreciation and capital gains must be changed to take into account real values measured in dollars of constant purchasing power. These major basic changes would mean

that the burden of income taxes could not be increased without congressional approval of higher rates, contrary to the present situation in which the burden of taxes increases even though Congress seems to be making minor reductions in rates.

Ending inflation will not be easy and will take several years at best. Inflation must be stopped, however, in the interest of national economic progress and of limiting the power of government over personal income and wealth.