296

FISCAL POLICY ISSUES OF THE COMING DECADE

HEARINGS

BEFORE THE

SUBCOMMITTEE ON FISCAL POLICY

OF THE

JOINT ECONOMIC COMMITTEE

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CONTENTS

CHRONOLOGICAL LIST OF WITNESSES

APPENDIX

FISCAL POLICY ISSUES OF THE COMING DECADE

TUESDAY, JULY 20, 1965

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON FISCAL POLICY
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to call, in room AE-1, the Capitol Building, Hon. Martha W. Griffiths (chairman of the subcommittee) presiding.

Present: Representative Martha W. Griffiths; Senators Paul H. Douglas and William Proxmire.

Also present: James W. Knowles, executive director; John R. Stark, deputy director; Nelson D. McClung, economist; Gerald A. Pollack, economist; Donald A. Webster, minority economist; and Hamilton D. Gewehr, administrative clerk.

Representative GRIFFITHS. The subcommittee will come to order. Today we begin hearings on fiscal policy issues of the coming decade. I am very happy to have all of you here. It is very kind of you.

During the years 1955 and 1957 predecessors of the present Subcommittee on Fiscal Policy under the chairmanship of Representative Wilbur Mills conducted major studies into the principles of using Federal taxes and expenditures to promote economic growth and stability. Papers submitted by professional economists and the reports of the hearings were published by the Joint Economic Committee in several thick committee prints. These materials have been a continuing valuable source of information to public officials, economists, teachers, and students of public finance, and many others interested in fiscal policy.

In the 8 to 10 years that have elapsed since the earlier studies were completed, much of the context in which we consider fiscal policy has changed.

Federal expenditures on a national account basis have grown from $70 to $120 billion, from 17 to 19 percent of gross national product. Changes in Federal Government expenditures and also in taxes therefore have potentially a more powerful impact on the level of income and employment.

More important, the climate of opinion in which fiscal policy decisions are made has changed. With the passage of the Revenue Act of 1964 the public in general, although not all of my district, accepted for the first time the principle of intentionally unbalanced budgets for economic stabilization. We have had unbalanced budgets before, and sometimes they have had stabilizing effects. Frequently, however, the stabilization effect has been accidental, and at other times the imbalance has been almost an incidental result of policies adopted to meet pressing popular demands that Government relieve acute economic distress.

But the reduction in taxes provided for by the Revenue Act of 1964 was made with the definite objective of stimulating an increase in income and employment, and the resulting improvement in income and employment has given the Nation a convincing demonstration of the power of fiscal policy for stabilization.

The present Subcommittee on Fiscal Policy is undertaking a review of the principles of Federal taxation and expenditures in the light of the problems and opportunities which now confront us.

The Joint Economic Committee is the only committee of Congress which has the responsibility to consider the overall economic effects of Federal taxes and expenditures.

We are certain that the findings and conclusions in the reports of the Subcommittee on Fiscal Policy published in 1956 and 1958 have survived the test of time very well, and are as pertinent today as then, but both the urgency and the prospect for the implementation of those recommendations are greater.

We expect in these and future hearings to define current major problem areas in Federal taxation and expenditures and to define effective means to their solution. In this endeavor we invite the cooperation of Federal agencies, professional economists, interested private organizations, and the public at large.

And we are happy to begin with the Council of Economic Advisers. Mr. Ackley, we will be happy to hear you.

STATEMENT OF GARDNER ACKLEY, CHAIRMAN; ACCOMPANIED BY OTTO ECKSTEIN AND ARTHUR M. OKUN, MEMBERS, COUNCIL OF ECONOMIC ADVISERS

Mr. Ackley. Mrs. Griffiths, thank you. We have submitted to your committee a rather extensive statement.

Representative Griffiths. I do appreciate the excellent statement.

Mr. Ackley. With your permission I would like to read it.

The Council of Economic Advisers welcomes the opportunity to appear before this distinguished subcommittee to discuss the fiscal policy problems facing the United States in the decade ahead. These problems are of crucial significance for our economy and our society: I congratulate the committee for its decision to investigate them.

Before looking ahead, it is well to recall where we are and to review the road we have traveled. And so I intend, first, to discuss briefly—

The evolution of ideas and attitudes toward fiscal policy;

The measurement of fiscal impact; and

Our recent fiscal performance.

CHANGING ATTITUDES TOWARD FISCAL POLICY

Ever since the passage of the Employment Act of 1946, there has been continuous advance in public understanding of the possibilities inherent in expansionary fiscal policy. A wide range of opinion, including leaders in both parties, gradually came to accept the view that, once a recession was clearly recognized, tax reductions or increased expenditures might be appropriate, even though they would enlarge the inevitable recession-induced deficit. This was in sharp contrast with the understanding of fiscal policy during the great depression of the 1930's.

But it was only more recently that a broader view of responsible fiscal policy began actively to be espoused. This view holds that it is the task of fiscal policy continuously to concern itself with the strength of markets in the economy, trying always to promote the generation of sufficient total demand for goods and services to allow the economy to produce at its full potential. This policy would not wait for recession to initiate expansionary policies, but rather looks for guidance at all times to the relation between the economy's productive potential and its anticipated production. Nor would it wait for actual inflationary pressures to appear before adjusting the budget in a restrictive direction.

I think it would be correct to say that, as recently as 1960, the idea of using discretionary tax and expenditure changes in this way was regarded skeptically by many—though by no means all—Members of Congress and the administration, and perhaps still more skeptically by the general public. Even economists were—and still are—not completely unanimous in judging whether fiscal policy can in practice be used to keep the economy close to full employment. Many have doubted our ability to forecast, or even to diagnose, with sufficient accuracy to take actions in time to be helpful. Moreover, many have feared that public concern over budget deficits and the unwieldiness of the tax and spending processes would prevent the timely and judicious use of discretionary changes in expenditures or taxes to keep the economy closer to a growth path consistent with reasonably full employment and reasonably stable prices.

The success of discretionary fiscal policy in the past few years, however, has had a considerable impact on the thinking of the public and the Congress, and perhaps even of economists. Under the leadership of Presidents Kennedy and Johnson, the Congress has taken an unprecedented series of actions to adjust fiscal policy to the needs of an expanding economy. I need not repeat to this group the details of these steps: the willingness to raise expenditures rather sharply in 1961 and 1962 without a corresponding increase in tax rates; the new depreciation guidelines and investment tax credit of 1962; the personal and corporate income tax reductions enacted in 1964; and the staged excise tax reductions which began last month and will extend in some measure through 1969.

The results of these actions have been gratifying—as much for their effect on public attitudes toward fiscal policy as for their tangible effects on the performance of the economy. A steady and long-lasting improvement in economic conditions has generated new public support for fiscal actions which serve to reduce chronic unemployment and to narrow the gap between potential and actual output. A large segment of the public and the Congress today holds that the Federal Government has an active responsibility to design fiscal programs which will—along with monetary policy—promote full employment, prevent a serious shortfall of actual spending below potential GNP, and regain equilibrium in the balance of international payments.

Much of this new public support undoubtedly reflects the realization, stemming from policies followed in recent budgets, that an expansionary fiscal program can be fully consistent with strong pressures for efficiency and economy in Government spending. Unfortunately, too many have in the past equated expansionary fiscal policies with loose spending practices, and with inadequate attention to governmental efficiency.

Moreover, support for fiscal policies designed to affect aggregate demand has been strengthened by the fact that they have been combined with programs designed to improve the structure of our economy—through manpower development and retraining, aid to education, and the antipoverty program; through revisions of tax structures to improve incentives; through efforts to assist lagging regions; through programs to improve civilian technology; and through efforts to modernize government regulation of industry. In short, it is recognized that we are moving toward a coherent combination of aggregative fiscal policies to maintain the growth of demand and structural policies to strengthen our ability to produce. Both aggregative policies and structural measures will be important in solving future problems and in increasing our range of opportunities. Today, however, we are concentrating on the role of fiscal policy.

MEASURING FISCAL IMPACT

All of us understand, in a general way, how fiscal policy works. Government expenditures add to aggregate demand and tax collections reduce it, by curtailing private purchasing power. But it is not possible to measure the impact of Government expenditure and tax policies, merely by looking at actual levels of disbursements or revenues. For example, Federal revenues automatically decline, and some Federal outlays—particularly unemployment benefits—automatically increase, when economic activity falls off as a result of a reduction in the intensity of private demand. The budget outcome has been altered, and the economy's decline has been automatically cushioned, but not because of any affirmative Government action. Rather, the budget has reacted passively to changes in the private economy. Discretionary fiscal policy has been absent.

The budget outcome is, of course, also altered by discretionary changes in tax rates or expenditures. But such changes in turn affect private demand, and changing private demand in its turn affects production and incomes and therefore Government revenues and outlays. The net outcome recorded in the Government's budget accounts in any year is a mixture of the effects of the affirmative fiscal actions taken, of the responses of the private economy to these actions, and of whatever changes in private demand are occurring independently of Government actions. We can separate out the extent of the discretionary fiscal actions alone, by measuring what would happen to the deficit or surplus at some given level of business activity. For this purpose we us a level of activity consistent with 4-percent unemployment.

Subject to some qualifications that I will mention in a moment, we can then assess the net impact of any Federal fiscal program for a given year by seeing what its various elements, taken together, would do to the full-employment surplus—the excess of revenues over expenditures that the fiscal program would yield if unemployment were at 4 percent. A full-employment budget which shows a smaller surplus results in a higher level of total demand than one showing a larger surplus.

However, when we are comparing the fiscal policy in effect in 1 year with that in effect in another year, an additional factor has to be taken into account. The level of activity consistent with 4-percent unemployment grows over time—as the labor force increases, and as its average productivity rises. And so the revenues consistent with 4-percent unemployment rise over time even with no increase in tax rates. In fact, with no discretionary action at all, the full-employment surplus would presently be climbing by some $7 billion a year. In short, changes in the full-employment surplus reflect not only discretionary changes in tax rates and expenditures, but also the effects of economic growth.

It is this fact that makes the full-employment surplus so significant and useful a concept. For the higher tax revenues that accompany economic growth, at constant tax rates, hold down private demand relative to potential output in exactly the same way that higher tax rates in any given year reduce demand relative to that year's potential output. This growth in potential revenues associated with the growth in potential output is what has been called the "fiscal drag." A constant set of tax rates and a constant level of Government expenditures exert an increasingly restrictive influence as time passes. In short, fiscal policy tightens by standing still in a growing economy.

In some years—when private demand is overly buoyant—we may want a fiscal drag to be operating, in order to avoid too high a level or too rapid an increase in demand. But on the average—and over the years—we need to offset much or all of the drag in order to permit the growth of demand to keep up with the growth of potential output. This is perhaps the most useful of the many insights we derive from the full-employment surplus concept.

However, the concept has limitations which keep it from being used as a precise tool of budgetary planning. In our own work, we use a much more detailed analysis in which each individual element of the Government's fiscal program is separately considered, along with changes in the private economy.

As several contributors to your recent compendium have pointed out, changes in the full-employment surplus are not a perfect indicator of the extent—and in marginal cases even of the direction—of the effects of fiscal policy. Any given totals of full-employment expenditures and receipts—and thus any given full-employment surplus—will have different effects on the economy depending on which types of taxes and which types of expenditures are included.

Moreover, generally speaking, a dollar increase in purchases packs a somewhat more expansive punch than a dollar cut in taxes, and a dollar cut in purchases is generally more restrictive than a dollar increase in taxes. This is because the full amount of a change in Government purchases constitutes a change in the demand for output.

In contrast, when taxes are raised or lowered, or when transfer payments are changed, it is the aftertax incomes of persons and businesses that are affected. Since consumers typically spend only a part of each additional aftertax dollar, or typically reduce spending by somewhat less than the fall in their aftertax income, the effect of a dollar of tax change is smaller than the effect of a dollar change of purchases. Further, where business taxes are concerned, tax changes produce effects on spending that may vary widely and cannot be estimated with precision. Thus the effects on demand resulting from a rise or fall in the full-employment surplus depend partly on the cause of the change in the surplus.

There are several other important points to keep in mind in interpreting changes in the full-employment surplus. One is implicit in what I have already said. The inherent strength of private demand changes from time to time. Some of these changes are related to what have been traditionally labeled "cyclical" factors—for example, the state of inventories. Others are longer-term factors such as the accumulated stocks of houses and capital goods, and still longer-term changes in population structure, tastes, and technology. Further, the prevailing monetary policy also affects the strength of private demand. As a result there is no one, permanent target level of full-employment surplus toward which we should strive.

Even in the short run, when these more basic factors are less susceptible to sharp change, we have to recall that various tax and expenditure changes operate with different, and perhaps variable, lags. As a result, quarter-to-quarter, or half-year-to-half-year changes in the full-employment surplus must be evaluated with special care.

Thus, the most significant use of the full-employment surplus concept lies in the interpretation of broad trends in the impact of Government fiscal policy on the private economy, both past and future.

THE RECENT FISCAL RECORD

The record of fiscal performance over the past decade provides a useful backdrop for viewing the challenge of fiscal policy in the decade ahead. Quarterly estimates of the full-employment surplus from mid-1955 to mid-1965 are presented in chart 1. The Council is indebted to Mrs. Nancy Teeters of the staff of the Board of Governors of the Federal Reserve System for her work in developing these numbers.

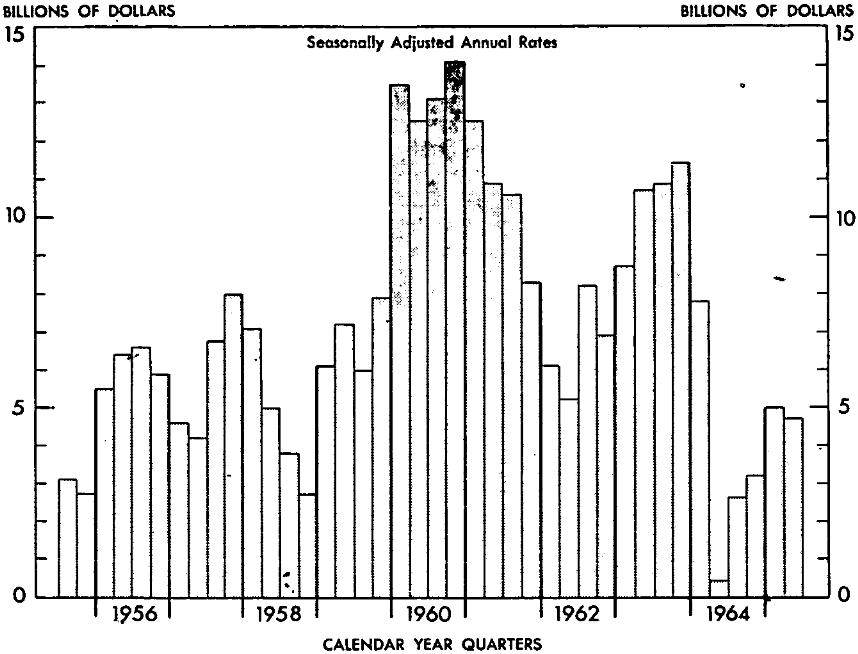
Let me point out a few of the lessons of fiscal history which are illustrated in the chart.

1. Excessively tight fiscal policy can clearly impair the advance of the economy. The most restrictive budgeting of the past decade occurred in 1960, when the full-employment surplus averaged $13 billion, or 2½ percent of our potential GNP, after a rapid rise from $7 billion in 1959. It is hardly coincidence that this sharp restriction in fiscal policy was followed by the recession of 1960–61, which resulted in a gap between potential and actual output of about $50 billion in the first quarter of 1961 and an unemployment rate of 6.8 percent. The private economy simply did not have sufficient buoyancy to overcome so large a net withdrawal of purchasing power and still achieve high levels of employment.

Another period of rise in the full-employment surplus occurred in late 1962 and 1963, when the growth of expenditures slowed and pay-

Chart 1.—Federal Full-Employment Surplus

NATIONAL INCOME ACCOUNTS BASIS



roll tax rates rose, while the income tax reductions proposed by President Kennedy were not yet enacted. This is the interval of slowest economic expansion in the past 4½ years, marked by temporary interruption of our progress in reducing unemployment. The quickening of activity in late 1963 was associated with increased confidence that tax reduction was to be forthcoming.

2. Conversely, the favorable influence of expansionary fiscal policy is also evident.

Our strong economic advance through 1964 and the first half of 1965 reflects the dramatic relaxation of the tax burden on the economy through the Revenue Act of 1964, with an unprecedented drop in the full-employment surplus shown on the chart for early 1964.

Previously in the decade, our periods of declining full-employment surpluses were confined to the tail end of recession and the early quarters of recovery. In both the 1957–58 and the 1960–61 recessions, the expansionary shift in fiscal policy occurred only in the final quarter of the recession. Once the shift was made, fiscal policy contributed actively to the support of recovery with a drop in the full-employment surplus of over $5 billion during the year 1958 and again during 1961. If recession should strike again, we should be prepared to act more promptly in supporting purchasing power.

Experience in the early postwar years also reminds us how the tasks of fiscal policy must always be adjusted to the strength of private spending. At times in the late forties, fiscal policy was as tight as in

1960. There has been no other occasion in our history when fiscal policy was so restrictive. Yet, with the benefit of hindsight, we would judge that in the late 1940's and early 1950's the budget, and monetary policy, should have been even tighter than they were, in light of the strain of demand on productive capacity. Private demand can be counted on to fluctuate; fiscal policy can help to maintain overall balance in the economy only if we are wise enough to recognize and to counteract these fluctuations.

Fiscal policy has helped to maintain overall balance in the economy in the period since 1960, through the changes in the full-employment surplus shown in chart 1. The detailed budgetary changes that produced this result are set forth in table 1. In the final quarter of 1960, our full-employment surplus was $14 billion. If tax rates had been unchanged, full-employment revenues would have grown by nearly $30 billion from then to the second quarter of this year. Had expenditures also remained constant at the level of the final quarter of 1960, the budget would have tightened steadily, with full-employment surplus aproaching $44 billion by this spring. The consequences for the economy would have been nothing short of diastrous.

Instead, the Congress and the Administration took expansionary actions totaling nearly $40 billion. We put to excellent social use the dividend of the $30 billion growth of full-employment revenues, as well as nearly $10 billion of the full-employment surplus.

Over the period, expenditures grew $27 billion, declining somewhat as a fraction of GNP. About half of the increase went into purchases —mainly for defense. Another notable change was the rise in Federal grants-in-aid to States and localities, from $6 to $11 billion. Tax cuts accounted for about one-third of the total expansionary actions.

TABLE 1.—*Federal fiscal actions, 1960 IV to 1965 II*

	Billions of dollars
Federal expenditure increases	27
Purchases	13
Grants	5
Transfers	7
Interest, subsidies, etc.	2
Federal tax reductions	13
Corporate	6
Personal	9
Social insurance	−3
Indirect	1
Total expansionary actions	40
Normal revenue growth at full employment	30
Change in full employment surplus	−10

NOTE.—Tentative and rounded estimates.

The tax changes reflected by mid-1965 include: (*a*) the 1962 revision of depreciation guidelines and the investment credit; (*b*) several small declines in indirect taxes, including the tiny portion of the current excise tax cut which applied to the second quarter; (*c*) a $3 billion increase in social insurance taxes in 1961, 1962, and 1963 (the only tax rate increases in the period); and (*d*) most significantly, the lower corporate and personal income taxes under the Revenue Act of 1964.

Since payments in the first half of this year partially reflected liabilities on 1964 incomes, the personal tax reduction still has not reached its full $11 billion value under the act.

There is nothing necessary, natural, or constant about the two-thirds, one-third division of fiscal moves between expenditure increase and tax reduction. Nor can the amount or composition of the expenditure rise be extrapolated into the future. But the record of the past 4½ years does show how a democratic society can meet urgent social needs, provide for tax reduction, and conduct a fiscal policy that helps to promote overall prosperity.

THE CURRENT FISCAL PROGRAM AND A LOOK AHEAD

The budget is expected to provide further stimulus to economic activity in the second half of 1965. The excise tax reduction and the anticipated enactment of improved social insurance benefits will combine with a moderate growth in Federal outlays to produce a decline in the full employment surplus to about $1 billion from its level of $5 billion in the past half year. This expansionary contribution of the budget should help to sustain the solid advance of the economy in the closing months of this year when we should expect to see some liquidation of steel inventories.

The continuing impact of these measures should also be working to maintain our forward momentum in early 1966. At that time, with the anticipated increase in payroll taxes to finance improved social security benefits and the new hospital care program, the full-employment surplus will rise but probably remain below its level in the first half of this year. Our best current judgment is that this fiscal program will meet the needs of sustained prosperity for the next 12 months. But events can alter our judgment, and out best insurance for continued advance lies in an alert and vigilant willingness to tailor fiscal policies to fit the economy's needs. The President's budget program and the other measures he will recommend next January will reflect a careful review of our economic prospects, and will be designed to sustain a steady and balanced advance of private demand next year.

Demand will have to continue to expand in the years ahead. Our productivity and our labor force will be growing rapidly, assuring a rapid growth in potential output which we can convert into better standards of living and greater wealth—provided that demand keeps pace.

Following the analysis set down in the annual report of last January, the Council estimates that the economy's full-employment growth trend will average 4 percent a year over the period to 1970. Assuming a continuation of the price experience of the present expansion, the full employment GNP in current prices would rise by about 5½ percent a year. Making allowance for the closing of the remaining gap between actual and potential production, we project a potential GNP for 1970 of about $895 billion.

Allowing for anticipated payroll tax increases and scheduled excise tax reductions but no other tax changes, Federal revenues at full employment in 1970 would be expected to approach $170 billion, a rise of nearly $50 billion over the indicated revenues of 1965 and of nearly $45 billion over full-employment revenues of this year. This is a good indication of the magnitude of the fiscal actions we will be considering over the next 5 years.

CHALLENGES OF FISCAL POLICY IN THE COMING DECADE

The potential growth of Federal revenues, approaching $50 billion by 1970, presents both an opportunity and a challenge to fiscal policy in the coming years. It presents an opportunity because of the large resources that the Federal Government can allocate to selected public or private purposes. The normal growth of expenditures in the social security and health insurance trust funds would probably absorb about one-fifth of our potential revenue growth. But that would leave around $40 billion to be allocated to various kinds of tax reduction, to various kinds of increases of Government expenditures, or to debt retirement.

But this fact also presents a challenge because—unless we make the right disposition of the potential revenue growth and at the right time—a large part of it could be aborted. If we fail to prevent a return of serious fiscal drag, if we leave our industrial capacity partly idle and permit unemployment to increase again, then the growth of our economy will be stunted, the resources of all levels of government will be smaller, our social problems will mount as we fail to provide job opportunities to many of our people, and our longrun ability to sustain our military and civil efforts abroad to preserve the free world will be weakened.

It is my belief that we will have the wisdom to manage our fiscal affairs so as both to create and to use wisely the opportunities inherent in the potential growth of resources disposable by the Federal Government.

This committee performed a singular service in gathering and publishing last February the views of so many outstanding private scholars and interested organizations on the fiscal policy issues of the coming decade. Their recommendations focused on four major topics: First, changing needs for Federal expenditures; second, continuation of the process of tax reduction and reform; third, strengthening our arsenal of weapons against recession; and fourth, Federal aid to our hard-pressed States and localities. I want to make a few brief comments on each of these topics.

Federal expenditures

The tax cut of 1964 has shown that expansionary fiscal policy can operate on the tax side as well as on the expenditure side of the budget. The steady growth of markets in line with our capacity to produce can be assured without a steady increase in the scope of the Federal Government. Certainly sustained prosperity does not require that the Federal share of GNP be enlarged.

This administration has demonstrated its determination to spend what needs to be spent to discharge our responsibilities in the world, but no more than is necessary. It has shown that there are great opportunities in such fields as health, education, and urban affairs to improve the quality of our public and private life. And it has found new ways to strengthen the total productivity of our economy through investment in natural resources, in science and technology, in public services, in assisting the development of backward areas and regions, and, above all, in the improvement of human resources. But it has also found that a rigorous pursuit of efficiency and economy in public programs of all kinds can release large resources for other programs of highest priority.

What the Federal Government must spent in the next decade to achieve our public purposes cannot now be foreseen. For the largest element in our budget, our national security outlays, the answer depends only in part on our own decisions. Nor do we yet know how far we can continue to discover potential savings through further reorganization, streamlining, and managerial efficiency, nor what new opportunities for sound public investments will be presented by technological changes and by new knowledge in the social sciences.

Thus we cannot be sure what part of our growing national output will be absorbed by Federal purchases. If our opportunities or responsibilities—particularly in defense—should mount sufficiently, we might even have to think in terms once again of tax increases. It is much more probable, however, that the growth of Federal expenditures will not exhaust the potential growth of our revenues and that tax reductions will again need to be considered.

Improving our tax system

We agree with most of the authors of papers submitted to the committee that our tax system needs to be further modified, not only to affect the overall level of revenues, but also to improve its structure. Important progress has been made in recent years, both in strengthening the tax system's incentives to promote industrial modernization, and in improving its fairness. But there is room for much more to be done.

There has been much recent discussion of the relative roles of direct and indirect taxes. At the Federal level, the 1962 and 1964 tax reductions reduced the relative importance of the direct personal and corporate income taxes. The recent reduction of the indirect excises will operate in the opposite direction. However, the postwar period has seen State and local government receipts grow much more rapidly than Federal receipts, so that total government—Federal, plus State-local—receipts have become more weighted toward "indirect" taxes—sales and property taxes—which bulk large at the State-local level. In 1964, indirect taxes—indirect business tax and nontax accruals plus business social security contributions—accounted for 43 percent of total tax receipts of Federal, State, and local governments. In 1947, by contrast, indirect taxes had represented 39 percent of total tax receipts. The generally regressive character of indirect taxes must cause us to be concerned about further reduction in the relative importance of Federal personal and corporate income taxes, and about further increases in payroll taxes.

In considering tax changes, the burden on low-income families particularly needs reexamination. The real value of the personal exemption has been substantially eroded since its present level was established in 1948, both by inflation and by the general growth of real incomes. This has substantially raised the burden of low-income taxation, particularly for families with several children. The projected increases in payroll taxes will raise further, and in a disproportionate way, the tax burden on lower income wage earners. At the present time, there seem to be sufficient incentives and reseources for the enlargement of capital facilities. Indeed, some business analysts are concerned that, if anything, capital facilities may be tending to grow more rapidly than the expansion of the ultimate consumer markets for the output of these facilities. This consideration—together with considerations of equity—strengthens the case for an early consideration of tax reduction at the lower end of the income scale. As the President said on June 21:

> When there is again opportunity for tax revision, we hope, in particular, to provide further tax relief to those in our Nation who need it most—those taxpayers who now live in the shadow of poverty.

There are many other areas of our system which require improvement, including estate and gift taxation. I am sure that Secretary Fowler will discuss some of these matters tomorrow.

Strengthening our arsenal against recession

Despite the unprecedented duration of our present expansion, we cannot assume that recessions are a thing of the past. Many economists have long felt that the single most important step this country could undertake to insure itself against serious recession would be to create a new mechanism which would permit quick, and possibly temporary, tax reduction. The President said in his Economic Report last January, "The Congress could reinforce confidence that jobs and markets will be sustained by insuring that its procedures will permit rapid action on temporary income tax cuts if recession threatens."

The Congress completed its action on excise taxes in just 32 days, demonstrating its ability to move swiftly on tax matters. But in this particular case, the Congress had had the benefit of full-scale hearings by the House Ways and Means Committee a year earlier. And the reduction of excise taxes could be on so large a scale that many of the usual controversies about the specific character of tax change were avoided. Moreover, these particular taxes were extremely unpopular, and were widely acknowledged to be poor taxes from almost any standpoint. Thus, the lessons of this experience are not entirely clear.

One lesson may be that previous discussion of the form and nature of an antirecession income tax cut can accelerate action when the time comes for it to be recommended. Some of the contributors to your compendium urged that Congress actually vote on the form which an antirecession tax cut should take, leaving the only necessary further action to be a simple vote putting it into effect, or refusing to do so, on the occasion of a Presidential recommendation. Earlier proposals by President Kennedy to go still further by providing a degree of discretionary authority to the executive branch understandably met little enthusiasm in the Congress.

Whatever solution is found to the difficult problems of mechanics, it is clear that increasing our tax flexibility represents a challenge of the very first order to the Congress and the country.

Opportunities for fiscal flexibility to fight recessions may also be found on the expenditure side of the budget. The problems, however, are many. Some expenditure programs are difficult to alter quickly. Moreover, antirecession increases in expenditures should not commit the Government to a higher level of outlays than would otherwise be desirable, once the economy had recovered. As we said in our last annual report:

> Advance planning makes possible a careful selection of those expenditure programs which could be most efficiently and most rapidly expanded in time of recession and contracted after recovery. This would assure that agencies have workable antirecession plans on hand, permitting speedier action by the administration and Congress and improving the efficiency of stepped-up expenditures.
>
> * * * Certain maintenance, rehabilitation, and modernization activities on Federal facilities, or on State and local facilities assisted by Federal grants, provide opportunities to push funds rapidly through already existing "pipelines." Unlike certain traditional public works, many of these activities could be expanded readily, employing workers without previous similar job experience and not requiring commitment to a long-term program. Various training and community service programs might also be intensified appropriately, since the poverty stricken and the unskilled are doubly disadvantaged in times of slack eco nomic activity.

It is still too early to evaluate fully the possibilities for anticyclical flexibility on the expenditure side of the budget and further intensive study is needed. There may also be opportunities to strengthen the contribution of our major systems of social insurance to economic stability, both on the receipt and benefit side.

Federal, State, local fiscal relations

Many of your contributors focused on the fiscal problems of State and local governments. Indeed, while Federal Government purchases of goods and services have absorbed a slightly declining share of the gross national product, State and local purchases have increased at a very rapid rate year after year, until at this time State and local purchases actually exceed Federal. At the same time, while Federal tax rates have been reduced repeatedly, State and local tax rates have increased steadily and many States have had to institute new taxes.

The rapidly growing revenue needs of State and local governments, the unsatisfactory nature of many of the taxes on which they rely, and the competitive problems they face in raising taxes all direct attention to the possibilities of altered fiscal relationships between the Federal Government and the States and localities.

Actually, although it has received little notice, the fiscal relationship between the Federal Government and States and localities has already undergone a revolution. Ten years ago total Federal fiscal aid to State and local governments amounted to $3.1 billion; in the current budget, Federal aid is programed at $13.6 billion, over four times as much. Whereas Federal aid contributed 10 percent of total State and local revenue in 1955, it will contribute about 17 percent in the current fiscal year. A private projection suggests that by 1970 Federal aid of the present types may well exceed $20 billion.

In this session of the Congress and the last, several important steps were taken to raise Federal aid. Much the most important, the new Federal programs for primary and secondary education at long last provide major Federal financial assistance for the single most important responsibility of State and local governments. In addition, the new economic opportunity program, and improved programs of public assistance, labor and manpower, health, and housing all help to

51-884 O—65——2

bring the fiscal power of the Federal Government to bear on State and local problems.

It is quite possible that additional aids may need to be explored. But it would be premature to draw any conclusions, either on the extent of State and local requirements or on the many alternate ways that might be considered for providing for them.

I have taken considerable time this morning to review the principles and the record of our fiscal policies, and to comment on some of the emerging issues before us. We can look back on solid accomplishments, and we can face the future with greater confidence because of the increased understanding of the basic principles of a fiscal policy. But the battle of public understanding is not won. Modern fiscal policy is still on trial. Many problems remain unsolved.

Unemployment is still at 4.7 percent and the average operating rate in industry is still below 90 percent. Our balance-of-payments problem remains, and price-cost stability cannot be taken for granted. Our techniques of analysis are still imperfect, and forecasting mistakes will be made. Our instruments of policy need to be sharpened, and made more flexible. And most important of all we must be continually alert to changes in the structure of our own economy and of the economy of the world.

It is through efforts such as those of your committee that all of us, both inside and outside of the Government, can exchange ideas and insights, and seek to identify the changes ahead before they are upon us.

Thank you.

Representative GRIFFITHS. Thank you very much, Mr. Ackley. I certainly want to express my appreciation and that of the committee for your excellent statement.

I even want to say that I think the first Subcommittee on Fiscal Policy chaired by Wilbur Mills did a fine job, and I think that your comments really have proven it.

Now I would like to ask you what additional measures do you think are necessary to achieve a 4-percent rate in unemployment?

Mr. ACKLEY. We in the council believe, Mrs. Griffiths, that the attack on unemployment must proceed in two directions. First we must expand total demand for goods and services and thereby expand the demand for labor to produce those goods and services. This is essentially the responsibility of fiscal and monetary policy.

On the supply side, we must continue our efforts to improve labor productivity and labor mobility, in order to make sure that as we move toward lower levels of unemployment we will not run into shortages of particular kinds of labor at particular places. We have begun some very important efforts in this direction through our job training and retraining programs particularly, and our programs for assistance to lagging areas.

I am certainly optimistic that these two kinds of attack on the problem will, in the years ahead, move us toward and perhaps below a 4-percent rate of unemployment.

Representative GRIFFITHS. Are you suggesting that the general stimulative effect of general fiscal and monetary policy is exhausted and that now we must direct our attention to the pockets of poverty?

Mr. ACKLEY. I certainly did not intend to suggest that. I think that we must always pay attention both to the supply and demand sides of this problem. Further, more rapid increases in total demand can continue to reduce the remaining excessive unemployment.

Representative GRIFFITHS. I would like to ask you specifically on the excise tax, if the excise tax reduction had been passed on would not the tendency have been to lower the cost-of-living index?

Mr. ACKLEY. Yes, we are very hopeful that the reduction in excise taxes will make a measurable contribution to the reduction of prices of previously taxed goods and services.

Representative GRIFFITHS. Well, now the cost-of-living index went up the first of July. Do you anticipate that it will go down the first of August?

Mr. ACKLEY. Let's see. I do not think we have either the June or the July cost-of-living figures as yet.

Representative GRIFFITHS. I thought it showed it had just gone up eight-tenths of 1 percent.

Mr. ACKLEY. The wholesale price index for June was announced yesterday. It shows a very disturbing upward movement of seven-tenths of 1 percent.

If we look at the composition of this movement we find that it was almost entirely the result of higher prices of farm products and processed foods. Within these categories the rise was concentrated in the area of livestock among the farm products, and meat among the processed foods. Both beef and pork prices, as well as cattle and hogs, have been rising considerably. This movement in agricultural prices is largely independent of the general balance between supply and demand in the economy. It primarily reflects movements in the cycle of beef and hog production. Obviously these movements at the wholesale level are going to be reflected in the Consumer Price Index for June, July, and August. The downward effects of the excise cuts may be outweighed by higher prices of food in the overall index in the next couple of months.

Representative GRIFFITHS. Should the excise tax fail to be passed on, in your judgment will the result be inflationary?

Mr. ACKLEY. If the excise tax cut is not passed on—and I am convinced that it will be in the overwhelming majority of cases—then obviously we do not get the price benefits we expect. Whether this makes it inflationary gets to be a rather complicated question. One could say that the most expansionary impact of the excise tax reduction is felt if it is in fact passed on to consumers, and increases the real disposable income available to consumers for buying.

Representative GRIFFITHS. Are you testing specifically whether or not the excise tax has been passed on?

Mr. ACKLEY. Yes, we are, Mrs. Griffiths.

Representative GRIFFITHS. What are your testing methods?

Mr. ACKLEY. We recognized last winter, when the question of excise tax reduction began to be discussed, that it would be important to have as good a record as we could get of what the actual effect on prices was when the excise taxes were removed or reduced. We secured the cooperation of the Bureau of Labor Statistics and the Treasury, therefore, in instituting a study which began to collect price information before the law was enacted.

We found that the regular price collection procedures of the Bureau of Labor Statistics were not entirely adequate to study the effect of excise tax cuts. Some of the taxed products were not included in their current price collection activities and the data were not always secured in a way which would give a clear-cut measure of the impact of the tax changes. We have instituted a program of collecting prices, both wholesale and retail, of as many taxed products as possible. This program began well before the excise tax cuts were put into effect. We are continuing to collect regularly those same prices so that we will be able to have a good measure of what actually happens.

Representative GRIFFITHS. Will you make that available to this committee?

Mr. ACKLEY. We certainly intend to make the study public.

Representative GRIFFITHS. What were your methods of testing the effect of the 1964 tax reduction?

Mr. ACKLEY. I wonder if I could ask my colleague, Mr. Okun, to discuss this?

Representative GRIFFITHS. Surely.

Mr. OKUN. We helped to initiate and have participated in some survey work that is being conducted by the Survey Research Center of the University of Michigan. They have been conducting consumer surveys for many years, and have established relationships between consumer incomes and consumer spending, and through special surveys are in a position to see how consumer spending has reacted to the income changes generated by tax reduction.

While these studies have and are continuing to produce interesting results, our chief approach to studying a change like personal tax reduction must be in aggregative terms. We must look at data for the economy as a whole. While one can never be absolutely certain of how the various factors in the economy have combined to affect consumer spending, it is clear that the strong rise that we have seen in consumer spending in the past year has been directly related to the rise in consumer income. Recent behavior of consumer spending is thoroughly consistent with our expectations that consumers would treat extra income generated by tax reduction the same way they treat extra incomes that come from other sources. The record of consumer spending in the past year really cannot be explained in any other way than by taking account of the higher incomes and take-home pay that people got through tax reduction.

We are still trying to make quantitative estimates of the effect that the tax cut on business incomes and the higher consumer spending —as it affected corporate sales—have had on investment spending. It is clear there has been an influence. But it is a rather difficult influence to quantify precisely. We are hoping over the summer to have more detailed estimates, although they will never be decisive, of this investment effect of the tax cut.

Representative GRIFFITHS. Well, now do you think it would be true before fiscal policy can be used intelligently that we will have to have more than a mere guess as to whether a tax cut is of help and what kind of a tax cut helps where and whom does it help, or whether expenditures help?

Mr. ACKLEY. I would not characterize our analysis of the effects of tax cuts as a mere guess, Mrs. Griffiths.

Representative GRIFFITHS. Well, I am sure they are not.

Mr. ACKLEY. I think economic analysis has established over the years the existence of some rather pronounced regularities in the way consumers in the aggregate behave when their incomes change. These are really quite dependable patterns of behavior, on which we can rely with considerable certainty.

As Mr. Okun suggested, it is much more difficult to analyze the effects of corporate tax changes on business investment expenditures. Clearly a reduction in the corporate tax rate, for example, does supply corporations with more funds for financing investment, but investment depends not only on the availability of finance. Higher corporate profits resulting from tax reduction also to some extent increase dividends and raise consumer incomes, and in this way enlarge consumer spending.

I think economists are beginning to have a better understanding of the factors that determine investment decision. They are complex and many. Taxes are only one of them. So it is still hard to quantify in detail the effect of business tax reductions on investment spending, and therefore on production and gross national product.

So far as consumer spending is concerned, however, I think that our understanding of consumer behavior has progressed to the point where we can make rather good estimates of what the impact of tax changes will be, not on the spending of individual consumers, but in the aggregate. Aggregate consumer spending does seem to be very dependably regular.

Representative GRIFFITHS. Does consumer debt go up or down when you have a tax cut?

Mr. ACKLEY. There are probably offsetting influences. On the one hand, some portion of the increased disposable income that consumers gain will be used to reduce consumer indebtedness.

It appears, as I suggested, that behavior of consumers in the aggregate is quite regular; namely, that they tend to spend in the aggregate approximately 93 percent of disposable income on consumer goods and services and save somthing like 7 percent of any change in consumer income.

Representative GRIFFITHS. Senator Douglas has just pointed out to me it goes up.

Mr. ACKLEY. Well, I thing the historical record has yet to be disentangled. On the one hand, there is the fact that some part of the increment of income will be used to repay existing debts. On the other hand, a rise in disposable income certainly induces some consumers to decide that they can raise their standard of living, which may involve new automobiles, new consumer appliances, and so forth. Financing such expenditures would cause them to go more heavily into debt than they were before.

Clearly the expansionary impact of the tax cut has resulted in increased purchases of automobiles and appliances, and a lot of that has been financed in part by increased installment debt.

Representative GRIFFITHS. Thank you. My time is up.

Senator Douglas?

Senator DOUGLAS. Mr. Ackley, I want to congratulate you on a very interesting report. You brought up from the economic underground, so to speak, into the broad sunlight of discussion two very interesting phrases—full-employment surplus, full-employment deficit, and the fiscal drag. And a good deal of the past analysis and future projections seem to hinge upon the legitimacy of those terms. I wonder if you would be willing to explain what you understand the full-employment deficit to be.

Mr. ACKLEY. Well, the full-employment deficit or full-employment surplus——

Senator DOUGLAS. Better take the deficit first.

Mr. ACKLEY. So far as our record goes, we have not found a full-employment deficit.

Senator DOUGLAS. How would you define a full-employment deficit so that you would know whether you had found it or not?

Mr. ACKLEY. For any particular period we calculate what the fiscal program of the Government would do to the balance between expenditures and taxes if the economy were operating at some prescribed level of employment.

Senator DOUGLAS. What is that prescribed level?

Mr. ACHLEY. For our calculations we have used 4 percent unemployment.

Senator DOUGLAS. Unemployment. And what percent of utilization of plant?

Mr. ACKLEY. There is no absolutely precise relationship between the two. But generally speaking, it appears that an unemployment rate of 4 percent would be reasonably consistent with an operating rate in manufacturing of something over 90 percent.

Senator DOUGLAS. Well, now this has to be conducted in a money economy.

Mr. ACKLEY. Right.

Senator DOUGLAS. What do you assume on prices?

Mr. ACKLEY. The measurement of the full-employment surplus or deficit, would be affected to some extent by changes in prices. But price changes would involve roughly equivalent expansion of both the revenue side and the expenditure side in dollars, so that——

Senator DOUGLAS. Well, I am not speaking so much of Government finances as in the private structure outside of Government. Now you say there is a full-employment deficit if the sum total of price tags on goods exceeds the sum total on goods which either are produced or could be produced with an unemployment rate of only 4 percent as compared with the total monetary purchasing power in the pockets of consumers?

Mr. ACKLEY. No, I think the concept of full-employment surplus as we have it in this paper——

Senator DOUGLAS. Well, now just a minute. We may be differing on the difference between surplus and deficit when the unemployment is more or less than 4 percent.

Mr. ACKLEY. We are talking, Senator, about the balance in the Federal Government's budget.

Senator DOUGLAS. But this has to be—you are using the Federal budget as a force trying to make for comparatively full employment, so you have to think of the patient whom you are treating.

Mr. ACKLEY. Yes, indeed. As I say, however, the full-employment-surplus estimates relate only to the Federal Government's budget on income and product account. All that the full-employment surplus tries to measure is what that budget would show in the way of surplus or deficit at a 4-percent level of unemployment instead of at whatever particular level of employment happens to exist.

For example, in 1964 the actual Federal budget on income and product account showed a deficit of about $5.1 billion. We have calculated, though——

Senator DOUGLAS. What do you mean by a deficit?

Mr. ACKLEY. An excess of Federal expenditures over Federal revenues. A deficit in the national income accounts Federal budget.

Senator DOUGLAS. Oh, that is the familiar budgetary deficit.

Mr. ACKLEY. Right. The full-employment deficit or surplus is the budgetary balance that would exist if the economy were operating at 4 percent, and it shows that in 1964 we would have had a surplus of about $3.5 billion.

Senator DOUGLAS. You are not considering then the stability of the economy, you are considering simply the Federal budget itself?

Mr. ACKLEY. Right.

Senator DOUGLAS. And therefore the Federal economy enters in only as a derivative.

Well, I had always thought that part of our budgetary policy since 1946, we should try to find out how we could so adapt governmental policies as to obtain comparatively full employment in the economy outside of government. Now apparently you do not touch that.

Mr. ACKLEY. I think that is our principal concern, Senator.

Senator DOUGLAS. Yes; but it is not expressed in this figure of yours.

Mr. ACKLEY. The full-employment surplus is a rather technical analysis of the Federal budget by itself. Obviously the Federal revenues and expenditures which result in a particular full-employment surplus or deficit have a great effect on the economy. Indeed our whole purpose in this chart that we have presented and the estimates that have been made is to indicate the way in which too large a full-employment surplus keeps us from getting to full employment and in fact produce actual deficits.

Senator DOUGLAS. Now you go to fiscal drag. You say there is a fiscal drag when there is a full-employment surplus?

Mr. ACKLEY. No; we have tried to define the term "fiscal drag" rather more narrowly. It is defined in terms of the drag on purchasing power in the economy that results from the normal growth of Federal revenues that goes along with the growth in our potential output. If our potential output grows at about 4 percent, or 3¾ percent a year as it currently is doing, then our Federal revenues would rise by something like $7 billion a year. Unless that drag is offset by either tax reduction or by an equivalent increase in Government expenditures, there is a drag on purchasing power, and therefore on the growth of incomes and production.

Senator DOUGLAS. Just a minute. Let's examine that. Suppose that were met by debt retirement and that Government bonds held by private individuals are purchased by the Federal Government. This gives additional purchasing power to private holders of these bonds, and they will either reinvest in private enterprise or possibly spend a little.

But why is purchasing power destroyed by that process?

Mr. ACKLEY. It is the surplus of taxes over expenditures that reduces or destroys purchasing power. The debt retirement neither creates nor destroys purchasing power. Purchasing power, unfortunately, is a slippery concept, and perhaps we should try to avoid using it.

Senator DOUGLAS. Well, it is what you say.

Mr. ACKLEY. It is used in the Employment Act, of course.

The retirement of outstanding bonds by the Treasury returns money to the hands of individuals, but it does not raise incomes to offset the reduction that comes from the Government surplus. We try not to use purchasing power to mean money, but rather income, and in the case of consumers, disposable income.

As you suggest, if the Government acquires the bonds from the private economy then the asset structure of the private economy is altered. The private economy holds more cash and fewer bonds. But we would not say that this increases purchasing power. It merely makes the economy more liquid.

Now this in turn may have some effect on spending because in the process of increasing the liquidity of the private economy through retirement of securities by the treasury, interest rates may be reduced, and some investment calculations——

Senator DOUGLAS. Well, my time is up, but when it becomes my time again I would like to have you go back to this point as to how purchasing power vanishes in thin air if the surplus is used to buy bonds and releases purchasing power of private individuals. Either you or I have been saved by the bell, I don't know which.

Representative GRIFFITHS. Senator Proxmire.

Senator PROXMIRE. I agree with Chairman Griffiths and Senator Douglas that this is a refreshingly different kind of analysis, one we certainly could not have expected a few years ago, even a year ago.

I am wondering, however, why there is almost no mention of the impact of monetary policy on fiscal policy here and no explanation of how the interest rate and the money supply, and so forth, affects the full employment surplus and affects fiscal policy.

I notice, for example, on pages 10 through 12 or 13 you analyze the entire effect of what has happened in the last couple of years on the basis of fiscal policy. Mr. Okun's response was to say that the only explanation he could find for the stimulus was because of fiscal policy.

I notice in the just released Economic Indicators that in the year 1959 there was a decline in the money supply; 1960, decline; 1961, an increase of 2 percent; 1962, 1½ percent; 1963, 4 percent; 1964, about 4 percent. And then if you add in time deposits there was a substantial increase in the money supply during these periods.

Now it seems to me that it is an inadequate analysis to try and explain what has happened to the economy in the last 24 months without regard to the fact that we have had a moderately expansive monetary policy. Isn't that correct?

Mr. ACKLEY. Senator, you asked why we ignored monetary policy in our discussion.

Senator PROXMIRE. I know it is very controversial.

Mr. ACKLEY. No; the primary reason we ignored it, or largely ignored it, was that these hearings are primarily to discuss fiscal policy.

We did recognize, Senator, the fact that the same fiscal policy will have different effects depending on whether the monetary policy that is being followed is restrictive or expansionary.

The reason why I think Mr. Okun was quite correct in attributing most of what has happened during the past several years to fiscal policy changes—along with other developments in the private economy—is that our monetary policy was really not changed very much over this entire period of expansion. I would characterize it as a reasonably neutral monetary policy. I would suggest that if monetary policy has changed in the past several years it has changed in the direction of becoming somewhat less easy, somewhat more restrictive.

Senator PROXMIRE. That may be in the last couple of months, but certainly the statistics indicate that there is a sharp difference between monetary policy in 1959–61 and the present time. The money supply at least has increased, increased quite sharply. There has been a continual increase in time deposits which has had much less effect, I presume, but at least some stimulative effect on the economy. The interest rate, which is perhaps a better index, has only increased slightly in this period of expansion and growth.

Your position is, monetary policy has been neutral, and from this I gather if monetary policy had been more expansive it would not have been necessary to have as much stimulation from fiscal policy; is that correct?

Mr. ACKLEY. Yes; I would certainly agree with that.

Senator PROXMIRE. Now there is another very interesting omission in your analysis that I think would have been impossible 10 years ago, and maybe impossible a year or two ago. There is no mention at all of the national debt. Here you are talking about a policy of increasing spending; a policy of cutting taxes; a policy of deliberate deficits; and you project in advance what is going to happen to the gross national product and to other things—in 1970. But there is no indication as to what will happen to the national debt in the meanwhile. Can you give us a projection of that?

Mr. ACKLEY. We have not tried to make such a projection, and I expect that it would be rather difficult to so so.

Senator PROXMIRE. Well, in this exercise do you anticipate between now and 1970 reaching the 4-percent level?

Mr. ACKLEY. This analysis simply asks how much tax receipts would go up if we reached the 4-percent level of unemployment in 1970. We have not tried to estimate what kind of fiscal policies would be necessary to produce an actual gross national product in 1970 equal to our potential product in that year, which we now estimate at $895 billion. It is very possible that the fiscal policy requirements for that kind of progress would involve deficits during at least some of the years of that period, in which case the national debt would grow.

Senator PROXMIRE. You say in your statement:

> Making allowance for the closing of the remaining gap between actual and potential product, we project a potential GNP for 1970 of about $895 billion.

This assumes you are going to close it gradually over this period. It does not assume you are going to close it between now and 1966, and I would assume, therefore, we can expect a series of deficits between now and 1970.

Mr. ACKLEY. I would not want to predict whether there would be a net Federal deficit between now and 1970 or a net Federal surplus which would permit debt retirement. I would guess, however, that unless private demand were appreciably strengthened by developments we cannot now fully foresee, it is very unlikely that we could achieve full employment by 1970 with a sizable net surplus over that period which would permit substantial debt retirement. I think that would be quite unlikely.

Senator PROXMIRE. You also anticipate about 1½ percent inflation each year—is that correct—rise in the consumer price level?

Mr. ACKLEY. The projection concerns the rise in the GNP deflator, which is a peculiar kind of price index. This price index has a number of unavoidable weaknesses, particularly in the way it treats the Government component of gross national product.

In periods of relative price stability, such as in the past 6 years, when wholesale prices have been essentially steady, the GNP deflator has continued to rise at about 1½ percent a year. We have simply projected that same behavior to 1970.

Senator PROXMIRE. You have just taken the past performance, and on that basis you think there is a logical expectation that we would have about 7½-percent higher price level 5 years than we have now?

Mr. ACKLEY. If I were trying to measure price stability in the economy I think I would not use the GNP deflator, although it is the only price that relates to the whole national product, and therefore the only one which can be used for this purpose. Our projection—I would not want to call it a forecast—implies about the same kind of price behavior that we have had over the past 4 or 5 years, which is virtual stability of the wholesale price index, some continued upward drift of the consumer price index largely in the area of services, and a GNP deflator rising at——

Senator PROXMIRE. I agree it is quite stable and it is an excellent performance from the standpoint of price stability, but do you think this at least gentle creep-up in prices is an inevitable part of encouragement in the economy picture? Is it possible for us to have even more stability in your judgment, or is this likely to be a factor that would affect expectations in a regressive way?

Mr. ACKLEY. I think one difficulty is the inevitable inability of our price indexes to measure adequately improvements in the quality of goods and services. Our Consumer Price Index has increased at an average rate of 1 to 1½ percent a year over the past 4 years. There are many economists that would argue that there has been no real increase in prices if we take full account of the improvements in quality.

Senator PROXMIRE. I wonder if maybe this is something on which the Council of Economic Advisers could be very helpful to the committee. I am chairman of the Statistics Subcommittee of this particular committee, and am very aware of the crucial importance of statistics. I wonder if you could make any recommendations or suggestions as to how we could improve the Consumer Price Index? This obviously is going to affect policy seriously. It could exert a significantly unfortunate effect, a very adverse effect, if people feel that the price level is rising when it is not, in fact.

If you can give us any specific suggestions I think it would be very helpful.

There is one other area which I think would be helpful to us. You are placing immense reliance on a single statistic, the unemployment statistic. The unemployment surplus is the basis for really the economic policy of this Government, because you are the Economic Advisers to the President and the Congress. Now I am very much aware, and I am sure you are, too, of the fact that this unemployment statistic is not satisfying because we do not have job-vacancy statistics. It is awfully hard to provide for a qualitative assessment in view of the fact that the technology promises heavy unemployment for unskilled and teenagers, and so on.

So that I think that if there is any way that we can refine and improve the unemployment statistic it would be most helpful to us.

Senator Douglas has pointed out the fact it does not allow for the fact that some people are frozen to their jobs and they may be producing very little, but they are considered employed. Others have part-time employment. And anything we can get to refine that statistic I think would be helpful in view of the fact that so much of our policy is based on this single figure.

Mr. Ackley. Let me comment just very briefly on that. As I am sure you are aware, there have been two recent reports that are relevant here. One is the report of a committee of economists on our price indexes, that was undertaken in—under the auspices of the National Bureau of Economic Research. The report, which is entitled "The Price Statistics of the Federal Government," was made to the Office of Statistical Standards, Bureau of the Budget. They suggested a number of ways of improving our price indexes—all of them, including the consumer index.

Many of these improvements would be rather expensive, and they would require extensive preparatory studies. Unfortunately very little followup work has been done on the basis of that rather extensive report.

There was also a report entitled "Measuring Employment and Unemployment," by the President's Committee to Appraise Employment and Unemployment Statistics, chaired by Professor Gordon about 2 or 3 years ago. The report made a number of suggestions for improving and strengthening those statistics.

I would certainly hope that your subcommittee, Senator, and the full committee, could give active support to the kinds of statistical programs that would be needed to improve our measures, both of price and unemployment.

Senator Proxmire. My time is up. Let me just ask, with the indulgence of the chairman, if you know whether or not this was called to the attention of Mr. Bowman in the Budget Bureau, because he has been very cooperative and anxious to improve these statistics in every way.

Mr. Ackley. Yes, he is certainly aware of both of these reports.

Senator Proxmire. Thank you. I will follow up on that.

Representative Griffiths. You have mentioned that some taxes and some expenditures have relatively a more powerful or less powerful punch than others. Would you name some of the more powerful and some of the less powerful?

Mr. ACKLEY. I think that tax reductions that go to consumers, and to low-income consumers in particular, are probably more reliably respent than other kinds of tax cuts.

That does not mean that there are not reasons for changing other kinds of taxes, too. But in terms of their impact on spending, I think probably tax reductions to consumers have the strongest punch.

Representative GRIFFITHS. How has this been checked—or has it been checked?

Mr. ACKLEY. We have a number of studies of the way consumers at different income levels use their incomes, and although these have to be interpreted with care, I think the data are fully consistent with the proposition that when low-income consumers get more income they spend the largest part of it.

As a general proposition, one can say that Government direct purchases of goods and services have the largest impact on production because they constitute a direct demand for additional goods and services in their full amount. A dollar of additional Government purchases of the services of its own employees or goods and services produced by private industry almost automatically creates a dollar's worth of extra production.

Representative GRIFFITHS. Now that is if the Government produces on-the-shelf goods, it acts faster than building dams?

Mr. ACKLEY. I was not really trying to distinguish between different kinds of purchases of goods and services. It is true that goods with long leadtimes may have their effects felt after a longer lag because of the time required in planning. This depends, partly, on how you measure these purchases, because we in fact measure Government purchases at the time the goods are delivered and the bills are paid.

A decision to increase purchases of goods with long leadtimes obviously has a slower effect on production and income creation than purchase of goods that can be produced promptly.

Representative GRIFFITHS. Do you have any studies that show the length of time that was required to put into effect a tax cut, a tax increase, or any particular program that the Government put into effect, such as, for example, roadbuilding?

Mr. ACKLEY. Certainly the record of the time that has been required to change taxes is a record that has illustrations both of very prompt action and of rather slower action.

In 1950 and 1951 the tax increases were enacted by the Congress very rapidly. Of course, then we had the special spur of an emergency.

As I suggested, the excise tax cut certainly was enacted with great speed. I have forgotten the time required for the Revenue Act of 1964, something like——

Representative GRIFFITHS. Ages.

Mr. ACKLEY. A year and a half between the initial decision in the executive branch to recommend it and the final enactment. That was a very complicated piece of legislation, of course. The timing problem on Government expenditures is more complicated. I think perhaps it might be useful to ask Mr. Schultze of the Budget Bureau what studies he may have of the time lags involved in expenditure changes.

Representative GRIFFITHS. Well, now I understand that some very informed economists are now of the opinion that at the end of the year things are going to begin to slump. How are you going to base your decision on any antirecession measures?

Mr. ACKLEY. Let me say to start with that we are not expecting a recession in 1965 or in early 1966, either. There has been, in some circles, a growing skepticism about the durability of our prosperity which, as you know, has already broken all past records for its duration.

But your question has to do with what we would do if there was an imminent recession.

Representative GRIFFITHS. Yes.

Mr. ACKLEY. Well, I think I am pretty clear about the kinds of recommendations the Council of Economic Advisers would be likely to make.

Representative GRIFFITHS. Good. What are they?

Mr. ACKLEY. If we were convinced a recession were imminent one measure we would consider recommending to the President would be a request to the Congress to initiate an emergency tax reduction.

Representative GRIFFITHS. And what taxes would you reduce?

Mr. ACKLEY. The simplest kind of antirecession tax cut would be a linear cut in the personal income tax. There are several simple ways to do it. One would be simply a flat percentage reduction in tax liabilities, or a flat dollar reduction. There are other possibilities as well.

The President suggested in his Economic Report this year that Congress should think in advance about what kind of a tax action it might take under those circumstances so that it could be prepared to act quickly, so that it would not have to spend a lot of time discussing the matter.

Representative GRIFFITHS. I wanted you to tell me. Now I would like to ask you why don't you suggest a cut or a suspension of payroll taxes?

Mr. ACKLEY. This certainly is an interesting idea. Indeed, I think there is a phrase in our testimony which suggests that our social insurance programs might be an area in which to look for possible antirecessionary measures.

What we primarily want, if we are trying to act in a hurry, is something that affects people's disposable incomes quickly; certainly if there were to be a cut in the income tax it ought to be one that affected the withholding rate immediately.

Representative GRIFFITHS. But the problem with the cut in the income taxes is that there is not any simple cut in income taxes. There are always difficult cases, and Congress is going to waste time discussing those difficult cases. Somebody is going to know a deplorable situation in which the tax should be cut, therefore you are going to spend a lot of time discussing, if you cut it for that particular person or group, what the effect is upon everybody else, and in general the tax authorities are not good enough to tell you. I mean they are not really competent enough to tell you what the effect will be. The one that would work absolutely, positively for everybody is payroll taxes for everybody employed.

Mr. ACKLEY. For nearly all employees; yes.

Representative GRIFFITHS. Well, what would be the effect if you cut it for them? What is the effect then upon those who are not employed, and how many such people are there?

Mr. ACKLEY. It is very difficult through tax reduction to help directly people who are not earning incomes. A cut in the payroll tax would, of course, raise questions about the social insurance trust funds.

Representative GRIFFITHS. You can replace the fund receipts from revenues.

Mr. ACKLEY. One possibility, as you suggest, is reimburse it from general funds. I think it is an interesting idea that ought to be studied.

Representative GRIFFITHS. Well, will you study it and tell us what happens?

Senator Douglas.

Senator DOUGLAS. Let's come back to the point we were discussing when the time ran out. The administrative budget of the Government has been operating at a deficit now for some years. Have we had a full-employment surplus or a full-employment deficit during these times?

Mr. ACKLEY. The chart attached to our testimony show that at all times over the past decade the Government has had full-employment surplus, and usually, a rather sizable one.

Senator DOUGLAS. So according to the realities, we have had an administrative deficit, but a full employment surplus. In other words, those two terms are not inconsistent with each other.

Now suppose the deficit had been greater, would the surplus have been greater or less?

Mr. ACKLEY. The full-employment surplus is simply a measure of what existing tax rates would yield in the way of revenues if we were operating at income levels consistent with 4-percent unemployment. If the full-employment surplus is too high the economy operates at actual levels so far below full employment that we run actual deficits. Indeed, that is what the whole exercise is about.

Senator DOUGLAS. This is what I am seeking to develop in this part of my questioning, namely, the relationship of the Federal budget to the private enterprise budget. You have virtually said there is very little connection between those two.

Now suppose you have what you say, a full-employment surplus, by which you mean that taxes at full employment would exceed expenditures. Would this constitute a fiscal drag?

Mr. ACKLEY. It would certainly mean that at high levels of employment there would be such a large Federal Government tax yield from the pockets of the public, that they would not have enough spending power to generate full employment production.

Senator DOUGLAS. Let me come to the question, why is unemployment above 4 percent? What are the ways of bringing unemployment down?

Mr. ACKLEY. Well, certainly the ways we have pursued—trying to reduce the full-employment surplus.

Senator DOUGLAS. By increasing the deficit?

Mr. ACKLEY. By larger expenditures, and by lower tax rates, thereby increasing private demand.

Senator DOUGLAS. Let me ask what would you say to an antitrust policy of reducing prices to match purchasing power instead of trying to pump purchasing power up to the level of prices?

Mr. ACKLEY. I certainly am a strong supporter of antitrust policy. I think it is a major element in our economic structure, an important one which helps account for our general economic success. However, I rather doubt that antitrust policy could or should be used as a major weapon of redistributing income from corporations to individuals.

Senator DOUGLAS. Well, if we had a competitive economic system would we have these difficulties which we are trying to remove?

Mr. ACKLEY. It is very difficult to imagine what a purely competitive economy would look like in the textbook sense of the term. It would be a very different economy. It would have many advantages. But perhaps it might also have some disadvantages. I think the kind of economy that our antitrust laws try to promote is not really the purely competitive economy described in textbooks.

Senator DOUGLAS. Well, not in the sense of an infinite number of producers each producing an infinitesimal fraction of the total supply. That, of course, is true. But is it not true also that the attempt to cure unemployment by fiscal means is apt to push into the background any emphasis upon antitrust policies as a means of increasing competition and getting prices reduced?

This is the way that I have always felt Keynes was generalizing and giving a false interpretation of what was happening in Great Britain. Great Britain ran for almost 15 years with high unemployment, and Keynes described various reasons which were monetary and fiscal in character. But all the English economists disregarded the fact that right under their eyes England was becoming cartelized. In industry after industry cartels would be formed. There would be complete monopoly—Imperial Chemicals and the rest; and as a result the competitive price structure was disappearing in England. They emerged after World War I with only five banks, for all intents and purposes.

Keynes assisted in cartelizing industry, and making industry less competitive. Robbins and Keynes—you never could get them to admit that monopoly or quasi-monopoly was a cause of continued unemployment, and they turned continuously to fiscal policy and monetary policy as a means of offsetting this weakness in the society about them.

And if monopoly is inevitable—if you cannot do anything about it —then I would welcome these compensatory movements. But I would want to be pretty certain that they do not push into the background efforts to introduce a greater degree of competition.

Now I wonder what your comments would be on that.

Mr. ACKLEY. I would merely express the hope that preoccupation with fiscal and monetary policy to maintain high employment would not divert attention from the structural problems of our economy, one of which is the problem of competition. I think the British economy today undoubtedly suffers from the stagnation of innovation, from rigidities, and from a nonprogressive structure which, at least in part, are attributable to the high degree of concentration in British industry.

Senator DOUGLAS. I do not like to label people, but I would say the new economics has contributed to this comparative indifference to competition, and has led to anesthetizing people, so that they do not have much emotional interests in antitrust policies or antimonopoly policies, all with the best intentions in the world I am sure.

Mr. ACKLEY. I would hope certainly that we could continue to progress both on the side of management of total demand and on the structural problems of the economy. We certainly ought to be able to keep both on the front burner at the same time.

Senator DOUGLAS. Well, how many front burners do you have? I have only seen two thus far, fiscal policy and monetary policy, but nothing for antitrust policy.

Representative GRIFFITHS. Senator Proxmire.

Senator PROXMIRE. It seems to me that it is quite important to determine which budget you are talking about when you talk about the effect. Did I detect that it was not too important whether you are talking about the administrative budget, the cash budget, or the national accounts budget?

Mr. ACKLEY. It is important which one we talk about.

Senator PROXMIRE. Which are you talking about?

Mr. ACKLEY. We ordinarily pay most attention to the Federal budget on income and product account.

Senator PROXMIRE. But when you are making analyses here, you are talking about the administrative budget; is that right?

Mr. ACKLEY. No, the estimates of the full-employment surplus are in terms of the budget on national income and product account.

Senator PROXMIRE. I notice that the national accounts budget has been in deficit until—this is on page 37 of the economic indicators—until the first quarter of this year. Therefore it was stimulating at this level of unemployment; is that correct? Your analysis, your whole thesis is that when the national income accounts budget is in deficit, it has a stimulative effect on the economy, and at this level of unemployment, regardless of whether it is at 4 percent, at this level of unemployment there is no question that it has been stimulative; is that right?

Mr. ACKLEY. That is correct in the sense that efforts to reduce this deficit by raising taxes or reducing expenditures would have created even more unemployment.

Senator PROXMIRE. Right, and during this period, in 1960 it had a drag effect, even at that level of unemployment, because there was a surplus. Since then there has been a deficit that has averaged around $4 or $5 billion, and it has fluctuated from $1.5 to $7.8 billion.

Mr. ACKLEY. That's right.

Senator PROXMIRE. And I take it that this means that during this entire period the contribution of the Federal Government has been stimulative.

Mr. ACKLEY. I think the best measure of the impact of the budget is not the actual figures, which reflect a lot of things, but rather the full-employment budget, and that is why we focused on it. But if you look at the chart, you do see that the full-employment surplus was very large in 1960.

Senator PROXMIRE. You say the full-employment figure. You can take 3 percent, 2 percent, 1 percent, but why not take what is going on right now? If it is 5 percent or 5.5 percent—right now it is 4.7 percent—if the national accounts budget is in deficit, is it not clear that the contribution of the Federal Government at this level tends to be stimulated?

Mr. ACKLEY. It tends to be more stimulative than if the deficit were smaller or if there were a surplus.

Senator PROXMIRE. If the deficit were greater, would it be more stimulative?

Mr. ACKLEY. The reason for focusing on the full-employment surplus is clear in these figures. We had very large tax reductions amounting, over the past four and a half years, to $13 billion net. That was stimulative. Yet you find that revenues actually, except for a minor dip, have been rising. We use the full-employment surplus or deficit concept to try to isolate the effect of the particular fiscal measures that are taken. If you look at the actual budgetary figures, you see a mixture of the effect of the discretionary fiscal policy changes plus the impact of these on the economy and therefore on revenues, all mixed up together. The only purpose—and it can be done in other ways—of the measurement of the full-employment surplus is to try to isolate the effect of the budget all by itself.

Senator PROXMIRE. This is beyond what I understood, and I am really learning something this morning. It seems to me you have not sold this to the President of the United States. The President of the United States just a couple of days ago said, "We need less spending. We need to cut down expenditures," and he called in his Cabinet officers and said, "We have to cut sharply."

Now you are saying that even at the present time you have a full-employment surplus of $1 billion. You said that in your analysis, and this analysis here shows that in the first quarter of the year the national income accounts basis even at the present level of unemployment was virtually in balance because the note says less than $50 million deficit.

Mr. ACKLEY. Yes.

Senator PROXMIRE. Which would indicate that the effect has been a drag now. It has been slowing down the economy. We have heavy unemployment. Yet the President is calling for economy.

Mr. ACKLEY. I think we have to keep separate the issue of efficiency and economy in the expenditures that we do make. I do not think any of us would disagree that whatever we are going to spend we ought to spend it efficiently and get the maximum results.

Senator PROXMIRE. Oh yes, of course.

Mr. ACKLEY. That is quite apart from the issue of what programs we should undertake and what levels of tax rates are needed to finance them. I see nothing inconsistent on the one hand with efforts to economize——

Senator PROXMIRE. That is always going on. The President is always urging that.

Mr. ACKLEY. Yes.

Senator PROXMIRE. And rightly so, and of course I approve and all of us approve that heartily. But this was a different kind of a meeting. He said at this particular time in view of the fact that we may have a further burden in Vietnam, in view of the fact that we may have additional domestic expenditures that we have to make, he seemed to feel that it was necessary to have a more stringent economy

51-884 O—65——3

program. He did not relate this to the usual appeal which is appropriate, and we all approve it, of getting more efficiency for the dollar.

It seemed to be a notion on the part of the President that we have to compensate for additional expenditures, defense expenditures, by cutting down on our domestic expenditures, and the whole thrust of your analysis here, it would seem, is that if we are going to stimulate the economy and get unemployment down to a lower level, that we are going to have to either cut taxes more, and there is not any program to do that now, or we are going to have to increase expenditures.

Mr. Ackley. I would simply repeat that the President is thinking about next year's budget. He wants to get the maximum social value out of that budget, the maximum return from what is being done. With the programs that have been recently enacted—education, health, antipoverty—and with the pressing needs to improve those programs as well as the defense situation, I think it is quite appropriate that he renew and intensify his drive to eliminate nonessential and, low priority programs, and to streamline operations.

I think this has to be kept quite separate from the question of the appropriate balance between overall expenditures and taxes. It is too easy to say that we will spend ourselves into prosperity just by being loose and careless about management of our public finances. I think the easiest way to defeat an expansionary fiscal policy is to be loose and careless in its management.

Senator Proxmire. We have had a substantial increase in the social security benefits legislated just a few days ago—it is still in conference.

Mr. Ackley. It is still in conference.

Senator Proxmire. But it certainly will be passed. We have a big and ambitious antipoverty program that is going to have a double effect, spending more money and upgrading the skills of our people, that we have a big and ambitious aid to education program, we passed a housing bill on the basis of estimates we made that should stimulate housing very greatly. One estimate was that the rent supplements alone will stimulate $6.2 billion worth of construction in the next 4 years over and above what we have had before.

Do you think in view of these Federal expenditures and their impact, that it would seem likely that maybe on the expenditure side—because of the social values involved—it will be possible for us to get the necessary stimulus without the tax reduction?

Mr. Ackley. I think that is still to be seen. If I were able to forecast next year's budget now, I would be a better man than I am. Decisions have to be made in the next 6 months as to the size of the desirable expenditure programs, and then we have to look at the strength of private demand in the private economy and see whether together they are enough to give us high employment. January is the time to reach that decision.

Senator Proxmire. One thing more. You made a very interesting statement relating to the regressive nature of State and local taxes, and the progressive nature—relatively—of Federal taxes, and the effect that Federal tax cuts generally tend to have in making the tax structure less progressive and more regressive.

In view of this, is there still an effort to share Federal revenues with State and local governments of the kind that there seemed to be a couple of years ago? That seemed to have a lot of support. Do you feel that it is still a good, strong possibility, or has this been pretty much forgotten, and the feeling that you can instead of that have an improved grant-loan basis to the States to overcome this fact.

Mr. ACKLEY. As I tried to indicate in my earlier statement, we already have had rather a revolution in the fiscal relationship between the States and the Federal Government. There are a number of ideas of new and further ways of diverting Federal revenues to assist State and local governments. These ideas are being discussed around the country and within the Government. There are a lot of possibilities. I do not think the Council, or the administration, is ready at this point to endorse any particular new way, but new ways certainly are under study.

Senator PROXMIRE. I do have one more question.

Representative GRIFFITHS. Go right ahead.

Senator PROXMIRE. We have not discussed balance of payments here. Balance of payments is always a predominant consideration when we are dealing with monetary policy. Yet it has not come up here at all either in your presentation or in any of our questions. In view of the fact that there obviously is a relationship, a relatively expansive fiscal policy tends to have something of an adverse effect on our balance of payments. This is still in the view of many people a very, very vital and important economic problem. Do you see in the next few years, assuming that the balance-of-payments situation has not been completely solved, any consideration here that would tend to retard an expansionary fiscal policy?

Mr. ACKLEY. Balance-of-payments considerations can never be divorced from domestic economic policy so long as the balance of payments remains a problem. There are opportunities, of course, to change the mix between fiscal and monetary policy. Our friends in Europe continue to insist that we ought to use a tighter monetary policy and a still more expansive fiscal policy so that we could simultaneously pursue both the objective of balance of payments equilibrium and of domestic prosperity. We think we have altered that mix in important ways, and that with the measures we are taking, we can attack our balance-of-payments problem successfully without having to sacrifice our domestic objectives.

But, clearly, balance of payments considerations in the past 4 years have had some influence on the degree of expansiveness that we have been able to contemplate in domestic policy. Perhaps this is unfortunate, but it is certainly to some extent true.

Senator PROXMIRE. It concerns me very much that we seem to tend to solve all our problems by higher interest rates, and there is not really much resistance from the public, and lower taxes, and, of course, enthusiastic support for that, and more pending, and there is enthusiastic support for that.

I think the only way we can overcome this bias is by a more forthright and vigorous defense of a mix, an appropriate mix of monetary policy on the part of economic leaders such as you gentlemen.

Thank you.

Representative GRIFFITHS. Supposing the full-employment surplus is too great in 1966. What plans do you have now for retarding it?

Mr. ACKLEY. We simply do not have any plans, because it is not clear at this point whether the full-employment surplus will be too great.

Representative GRIFFITHS. Well, what do you think would be the best thing to do? Would you attack it from the fiscal policy level or are you going to attack it from the monetary level?

Mr. ACKLEY. I think our ability to use monetary policy will continue to be somewhat limited by the balance-of-payments considerations that we were just mentioning, and that the primary attack on unemployment and the means for sustaining prosperity have to be found on the fiscal side.

Representative GRIFFITHS. So what would you think would be a good idea, if you were just throwing ideas? What, among several ideas? If you think it is difficult to reduce taxes, how difficult will it be to increase them?

Mr. ACKLEY. Everything is difficult. The big question mark which confronts us today in thinking about fiscal policy for fiscal 1967 is the size of the defense budget. I think until we have a clearer fix on that, it is very hard to make any judgments about the need for tax reduction or tax increase. That is an unknown.

Representative GRIFFITHS. Do you not think that the time has come to make some plans on how it would be done——

Mr. ACKLEY. Oh, certainly; we are already engaged in planning.

Representative GRIFFITHS. To investigate some possibilities and to check out the problems involved in reducing any program or in increasing taxes?

Mr. ACKLEY. Well, I am certainly very hopeful that we will not have to be considering tax increases in 1966. But I am sure that Secretary Fowler and Director Schultze can give you more information on the contingency planning that is continually underway.

Representative GRIFFITHS. You pointed out there is no constant level of full employment surplus to which fiscal and monetary policy may aim. Does this mean you have to forecast it quarter by quarter or year by year?

Mr. ACKLEY. Yes; I think that is exactly what it means. The appropriate level of the full employment surplus or the appropriate posture of fiscal policy has to depend on one's estimate of what the basic strength of private demand will be.

Representative GRIFFITHS. How accurately can you make the forecast?

Mr. ACKLEY. I certainly do not want to appear other than very humble about our ability to forecast. I do think that our ability to forecast has greatly improved in recent years, but I am sure we will make further mistakes. I am comforted somewhat by the fact that, for the last 2 years, the forecast of gross national product provided by the Council of Economic Advisers has been very close to being on the nose, and I think it will be for 1965.

But we certainly cannot count on the same degree of accuracy. Nevertheles, limited as our ability to forecast may be, I think intelligent behavior requires us to do the best we can.

Whatever we do there is an implied forecast in it, and we ought to be as systematic and as professional as we can in trying to assess the strength of private demand: what is going to happen to housing construction next year; how strongly business will be expanding its investments; what is likely to happen to inventories.

Representative GRIFFITHS. And what do you suggest on fiscal and monetary policy?

Mr. ACKLEY. It is obviously related to our estimate of the strength of private demand.

Representative GRIFFITHS. So you will have that in your annual report.

Mr. ACKLEY. Yes.

Representative GRIFFITHS. You say that, although we have acted too slowly in checking past declines in demand, we shall act more promptly in the future. Does this reflect better warning, improved forecasting, or the institution of procedures for taking fiscal policy actions with greater alacrity, or both?

Mr. ACKLEY. I think the word was not "shall" but "should" act with greater speed. I think that all of these things you have mentioned are important in improving our ability to act quickly.

Certainly improving our forecasting, perhaps being more forthright as to what we think is going to happen. I believe that in the past, when even within the Government recessions were foreseen as a strong possibility, the administration has not always been fully frank in communicating to the Congress the possible need for action.

I think one requirement is that the administration first forecast as best it can, then recognize the requirements and make its recommendations to Congress. Hopefully, Congress can perhaps improve its procedures for acting quickly when such recommendations come forward.

Representative GRIFFITHS. Thank you.

Do you have further questions?

Senator PROXMIRE. No questions, thank you.

Representative GRIFFITHS. I would like to thank you again, Mr. Ackley and gentlemen, and I would like to say I understand that Home once said that he had two problems as Prime Minister of England—the political were insoluble, and the economic were incomprehensible—and I would like to thank you for making ours more comprehensible.

We will meet tomorrow at 10 o'clock in this room, and Under Secretary Joseph W. Barr, of the Treasury Department, will be the witness.

(Whereupon, at 11:55 a.m., the committee recessed, to reconvene at 10 a.m., Wednesday, July 21, 1965.)

FISCAL POLICY ISSUES OF THE COMING DECADE

WEDNESDAY, JULY 21, 1965

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON FISCAL POLICY
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to recess, at 10:07 a.m., in room AE-1, U.S. Capitol Building, Hon. Martha W. Griffiths (chairman of the subcommittee) presiding.

Present: Representatives Griffiths, Widnall, and Ellsworth; Senator Proxmire.

Also present: James W. Knowles, executive director; John R. Stark, deputy director; Nelson D. McClung, economist; Gerald A. Pollack, economist; and Hamilton D. Gewehr, administrative clerk.

Representative GRIFFITHS. The committee will be in order.

We will start. Thank you very much for being here, Mr. Barr, in spite of the reluctant elevator.

You may begin.

STATEMENT OF HON. JOSEPH W. BARR, UNDER SECRETARY OF THE TREASURY, ACCOMPANIED BY GERARD BRANNON, OFFICE OF TAX ANALYSIS, U.S. TREASURY

Mr. BARR. Madam Chairman, I appreciate this opportunity to present to the Joint Economic Committee some Treasury views on our approach to long-range fiscal policy. It is clearly important that from time to time we look beyond the horizon of short-run decision problems that necessarily absorb so much of our attention. The subcommittee should be congratulated on its effort to place these problems in perspective. The initial publication of the statements of invited economists and organizations has already provided a useful compendium of views on the issues that lie ahead and possible ways of dealing with them.

THE SETTING FOR FISCAL POLICY

In approaching this topic of fiscal policy over the next decade, I would first like to emphasize several basic aspects of the setting in which fiscal policy in used. Perhaps most fundamental, we should recognize that we are dealing with one of several instruments of economic policy. Further the broad policy goals are already set forth in the Employment Act of 1946, which commits our Government to seek sustained growth in employment and income in, by implication, an environment of stable prices, all within a framework of a competitive private enterprise system.

That act was a historic step. In the two decades which have followed we have made tremendous strides toward the realization of its objectives—not least by the intelligent and more active use of the tools of fiscal policy. Obviously we still have much to learn, but the improvement of techniques and data for appraising economic developments and a better undestanding of our policy tools have both enabled us to realize more fully the tremendous contribution that appropriate fiscal policies can make toward achieving the potential of our economy.

However, let me make one thing quite clear. Under our economic system, by tradition and choice, we place primary reliance on the vigor and skills of our private economy to achieve the objectives of the Employment Act. We reject detailed government of production, consumption, and investment, and direct controls to implement such plans.

This does not mean, of course, that Government policies—and particularly tax and expenditure policy—do not affect the environment in which private decisions are made, or that they do not have a powerful influence on economic activity. Obviously they do. But, it does mean that Government cannot itself supplant the market, and that in shaping decisions on fiscal policy we must be alert to the shifting forces in the private economy and to the need to provide constantly a fiscal environment in which these forces can best operate.

There are no magic formulas for fiscal policy applicable to all the variety of problems and needs that may arise. For instance, those few who would still insist on reaching for a balanced budget year in and year out fail to recognize the influence that these taxing and expenditure decisions may have for the performance of the entire economy. Experience shows there are situations in which the forces of expansion in the private economy are not adequate to fully employ our workers and our resources, and in which the level and structure of taxes may themselves be impeding the required growth and investment. In circumstances like these, an effort to balance the budget may be self-defeating if the result is only to further restrain economic activity and to constrict the tax base. Instead, tax reduction may be an essential means of releasing the energies of the private sector, even if projected revenues do not fully cover anticipated spending. Conversely, at times when demand threatens to outrun our capacity to produce, responsible fiscal policy may require tax increases and a budgetary surplus.

This approach by no means implies loss of firm and effective controls on expenditures—a never-ending effort to assure a dollar of value for every dollar spent. Nor does it entail losing sight of the goal of a balanced budget. Rather, it emphasizes the importance of seeking that goal within the framework of a healthy, expanding economy. And it recognizes that that goal is dependent not only upon decisions concerning the level of tax rates and expenditures, but upon all the complex forces at work in the private economy and in other areas of Government policy that importantly affect economic activity, including the structure of our tax system, developments in the credit markets and in monetary policy, and the management of the public debt.

EXPERIENCE SINCE 1961

Our approach toward fiscal policy can, I believe, be illustrated by our experience since 1961. Our fiscal policy recommendations over this period have been made only after painstaking and at times painful evaluation of all relevant economic data and exhaustive consultations with a broad cross section of outstanding economic authorities representing the views of virtually all sectors of the economy. The approach seems to work, since during this period the Nation has experienced the longest peacetime expansion in history, and our price level has been the most stable of any industrialized nation in the free world.

In January of 1961 we were confronted with an economic recession which obviously required expansionary policies. Unfortunately we also faced a balance-of-payments deficit of nearly $4 billion. Under these circumstances, it was not feasible, in an attempt to promote expansion, to push monetary policy to extremes of ease for that could only have aggravated the capital outflows that were materially contributing to the outflows of dollars.

Instead, our response to the recession and to the broader pattern of slow growth that had developed in the late 1950's was to encourage expansion through fiscal policy. Our analyses of the economy indicated very clearly that our problem centered in domestic investment. Faced with necessary increases in defense expenditures in 1961, a broad program of tax reduction was not immediately feasible. However, it was possible, without excessive loss of revenue, to develop an investment tax credit and liberalized depreciation guidelines for productive equipment tailored to providing increased incentives for productive investment—investment that not only would pay dividends in terms of domestic growth but would also help to buttress our international competitive position.

Recovery proceeded through 1961 and into 1962, but as the economy absorbed the higher level of defense spending it was apparent that unemployment was still too high, and that prospects for sustained and vigorous growth continued to be impeded by our tax structure. Calculations showing what the budget would look like if we were operating at full employment indicated a sizable surplus. The difficulty was that the tax rates that produced that large "full employment surplus" were so high as to thwart the growth in the economy necessary to reach full employment. Stated another way, as the economy came out of the recession, the high marginal rates of taxation drained off so much of the added purchasing power that markets were not available to match our full productive potential. There was good reason to believe that these high tax rates, enacted to offset the inflationary pressures caused by war and postwar defense needs many years earlier, were no longer appropriate. Our primary problem was obviously not inflation, but slow growth, high unemployment, and periodic recessions. The solution lay in greater incentives to invest combined with a measured release of purchasing power.

This objective required a carefully balanced program of tax reduction spaced out over time, and we proposed cuts in both corporate and individual rates combined with substantial improvements in our entire structure of income taxation. The result was the $14 billion two-stage tax cut enacted in early 1964, the largest in history. At the same time, a tight lid was imposed on expenditures, assuring that the tax reduction could be absorbed without inflation and consistent with reduction in our budgetary deficit.

Finally, this year we were able to recommend elimination of many of our exise taxes, removing another impediment to growth while improving our tax structure.

THE BASIC OBJECTIVES OF FISCAL POLICY

In extracting lessons for the future from this experience, I want to emphasize that none of us can be sure what the particular problems of tomorrow will be—whether inflation or recession, increased military spending requirements, or what. We can be sure, however, that we must be prepared to use our fiscal policies flexibly, as required by unfolding events, and not be bound by doctrinaire beliefs. And we have learned much of the varied potential of fiscal policy in combination with other economic policies—to fight inflation or deflation and to encourage consumption or investment. Moreover, we will have before us in guiding these decisions the basic continuing objectives of all our economic policies—each implicit in the Employment Act of 1946. These include—

(1) Maintenance of an adequate economic growth rate with a broad and equitable distribution of income.

(2) Provision of adequate levels of those essential services that we buy collectively through Government expenditures.

(3) Maintenance of reasonable price stability.

(4) Preservation of healthy levels of international trade and investment along with equilibrium in our balance of payments.

RECONCILING THE GOALS OF POLICY

We suggest that a basic concern of this committee in examining long-range fiscal policy should be to study more intensively the interrelationships between these goals and the adequacy of our existing fiscal policy instruments for achieving them. Let me direct your attention to some of these interrelationships.

In recent discussions of economic policy, there has been much concern about finding a blend of policies to achieve multiple objectives—objectives that, at least in the short run, sometimes seem partially conflicting. For instance, experience suggests that, as our objective of full employment is more closely approached and the economy operates with a smaller margin of excess capacity, then problems of maintaining price stability increase.

The active and intelligent use of fiscal policy, has, I believe, contributed to reconciling these goals. Certainly, the record is clear that our sustained advances in economic activity have been accompanied by substantial stability of the wholesale price index. True, there has been some updrift in the Consumer Price Index of about 1 to 2 points a year, but part of this updrift may be associated with our inability to make full allowance for quality improvement within the index itself. This is clearly involved in one of the most rapidly increasing components, the cost of medical services. Altogether our price performance over the past 5 years has been far better than that of our leading competitors in world markets.

The administration has been conscious of the inflation problem in formulating its fiscal policies. In a situation marked by excess capacity and excessive unemployment, we were convinced that a tax cut, intended to spur growth and reduce unemployment, would not lead to inflation. We have not, on the other hand, sought to drive to unsustainable goals simply by massive injections of purchasing power. Instead, reductions in consumer taxes have been accompanied by measures to provide investment incentives, to encourage steady growth in capacity, and to promote efficiency in productivity. At the same time, we have recognized that the whole burden of reconciling these goals could not be placed on fiscal policy alone, and that our fiscal program needed to be implemented with full awareness of the need for complementary policies in other areas. Thus, monetary and debt management policies have been carefully coordinated to assure that Federal deficits would not result in excessive liquidity that might give rise to future inflation. And, we have begun to deal directly with problems of structural unemployment—by manpower training and development, the economic opportunity program, Federal aid to education, and the like.

Our ability to achieve an unemployment rate of 4.7 percent without widespread price pressures represents substantial progress over earlier experience, but we must push ahead to extend our gains.

Fiscal policy will continue to have a key role to play in that effort, but it must not be called upon to do the job alone. Let me point out, for instance, that unemployment among particular groups, such as Negroes and teenagers, tends to follow the ups and downs of the national average, but the rate among Negroes stays twice as high as the total rate, and the rate among teenagers stays almost three times as high. Progress toward our social goals of improving the position of the underprivileged and reducing juvenile delinquency certainly requires that we improve job opportunities generally, and fiscal policy can help assure the expanding markets essential to provide those opportunities. But adequate job opportunities for minority groups and for teenagers—consistent with orderly, noninflationary growth—will also require action to reduce and eliminate structural imbalances in our labor market.

Our use of fiscal policy in recent years has also been influenced by the need to reconcile the goals of balance-of-payments equilibrium with domestic growth. One way of encouraging a higher level of domestic investment would have been very low interest rates, but we have learned that in a world of increasingly free trade and payments, no country can afford to ignore the relationships between its own money markets and those abroad. The use of fiscal policy—and particularly tax reduction—offered an alternative. Some measures could be centered directly on investment incentives, such as the investment tax credit, the depreciation reforms of 1962 and 1965, and the corporate tax cut of 1964. More generally, the spur to overall economic activity through reduced tax rates, as it works its way through the economy, provides a more attractive environment for the employment of capital domestically, tending to reduce incentives to the outflow of capital rather than increasing them, as would have been the case with extremely easy money.

In this way, the increasing integration of the world economy has required the United States to explore and use the potentialities of fiscal policy much more fully. I believe that these external considerations will remain important in the choice of policy tools, not only for the United States but for other industrialized nations as well in the years ahead.

THE CHOICES FOR THE FUTURE

As we look into the future, and consider the range of issues that will be confronting the fiscal policymaker—such as the need for tax rate reduction as against expenditure increases, possible changes in State and local government fiscal relationships, and the alternative of debt retirement—it is useful to emphasize that a growing economy will year by year generate higher revenues at existing tax rates. This tendency—sometimes referred to as the fiscal drag—presents a clear-cut need to make choices, and much recent discussion has centered on what these choices should be.

For instance, a summary of the replies of 48 economists and 10 organizations to the questions put by the chairman of this subcommittee, stated that:

> The consensus is that during the next decade, Federal revenues are apt to rise faster than Federal expenditures, thus exerting a drag on the economy. The respondents were hesitant, however, on recommending the proper remedy for fiscal drag, with no clear-cut consensus emerging for either increased spending or for further tax cuts.

This absence of a consensus seems to me to be readily understandable, for the kind of choice implied is dependent upon a host of other judgments on more particular problems and objectives. First, the degree to which rising revenues may be divided between reduction of the budget deficit or to debt reduction, lower taxes or higher spending, can be based only on a thorough analysis of the impact of these alternatives on the national economy under prevailing conditions. Clearly, lower deficits or a surplus applied to retirement of the debt would be in order if the Nation were at full employment and if inflational pressures were great. On the other hand, if economic projections indicated sluggish growth and no price inflation, such a policy would not be in order.

BALANCING SAVING WITH INVESTMENT

In considering this issue, we should recognize at the beginning that in our economy borrowing is a necessary concomitant to savings. To take a simple and obvious example, a savings bank can only operate if somebody borrows the money in order to spend it and put it back into the income stream. In addition to lending by individuals, the growth in the money supply required by an expanding economy requires annual increases in net borrowing from commercial banks.

To some extent, of course, savings get back into the income stream through direct investment by the saver or through the purchase of equities. In quantitative terms, however, this represents a relatively small portion of the use of personal savings in our economy. The bulk of our savings must be absorbed by willing borrowers, and put back to work in the economy if we are to achieve sustained increases in employment and output.

We believe that it is desirable that over time a maximum amount of the vast supply of savings the economy is capable of generating should be absorbed by borrowers within the private economy or by State and local governments. In fact, over the postwar period, about $700 billion of such savings have been absorbed by the private economy—nearly $300 billion by corporations, $230 billion by home mortgages, $70 billion by consumer credit, and about $100 billion by other borrowers. About $70 billion was absorbed by State and local governments. About $40 billion has been absorbed by the Federal Government itself.

A properly designed tax structure can make an important contribution to the private absorption of savings by minimizing any discouragement to investment that might arise from the magnitude of taxes that we have to collect. We could, for example, have obtained about the same dollar amount of revenue from corporations by providing a combined top rate of 46 percent, instead of the present 48 percent, but without an investment credit. We are convinced, however, that collecting this amount of money through a structure that does have an investment credit will result in a larger amount of private investment, and thus more private absorption of savings and less need for Federal deficits.

With a carefully designed tax structure and policies in other areas to encourage investment, there is every reason to believe that a healthy economy operating at full employment will be capable of generating adequate investment outlets to absorb all our potential savings. Certainly, we should aim for this kind of healthy investment climate. And, under these conditions, a budget balance is appropriate, or a surplus which will release funds from the Federal Government to help meet the needs of private investment.

In other circumstances, however, private investment demands may not be great enough to absorb all the savings we are capable of generating. Then Federal absorption of some of our savings means a highly useful purpose, for those savings, instead of being diverted from the spending stream, and thus tending to restrain the level of economic activity, can be carefully employed.

Federal uses of savings are in quite important ways productive in the same sense in which business investment expenditures are productive. Certainly the Federal Government requires buildings, equipment, and powerplants and other items—the same kind of things financed by private borrowing. Much of what is currently labeled as Government expenditure is devoted to producing assets which will be providing services for many years in the future.

One kind of productive Federal investment is increased investment in people—namely, the investment represented by improved education. This we have attempted to advance on many fronts from aid to elementary education through aid to colleges and graduate training and to vocational retraining. This kind of investment in people will be particularly advanced by the adoption of the program to provide scholarships, student employment, and guaranteed subsidized interest loans for college students from low and middle income families. This kind of a program, unlike the proposed tax credit schemes, is concerned with opening up college opportunities for capable students who cannot afford college.

Moreover, in considering this issue of the Federal debt, its relation to total output is important. Between 1960 and 1965 while our GNP will have increased by 30 percent, the public debt has increased by 11 percent. It has fallen from about 52 percent of our GNP to about 49 percent. This period included 3 fiscal years in which the deficit was over $6 billion.

Currently, the Federal deficit has been reduced considerably below the average level of those 3 years.

I am sure you all noticed the statement by the President yesterday that the administrative budget deficit for fiscal year 1965 totaled $3½ billion.

The point is, however, that even in those years of larger deficits, the debt was getting smaller relative to our capacity to deal with it.

EXPENDITURE INCREASES AND TAX REDUCTION

The proper mix between tax reduction and expenditure increase—when the growth in revenues makes this possible—cannot, in my judgment, be decided apart from specific decisions as to particular needs at particular times. The very magnitudes involved mean that this situation opens up dramatic opportunities to improve our society. The compendium deals with many of these, including major tax rate reduction, assistance to State and local governments, the use of general revenues to meet part of the costs of social insurance now covered by payroll taxes, and a larger scale attack on the problem of poverty. There will be others as well and all merit careful debate and analysis.

I am sure that, in testifying before you tomorrow, the Director of the Bureau of the Budget will deal with the kinds of specific and particularized choices entailed in expenditure decisions. For my part, I would like to close by briefly touching upon a few of the more important issues that arise, and must be decided, in connection with further tax reduction.

Perhaps most important, we must continue to be concerned about the impact on our tax structure on the entire distribution of income. We have reduced the impact of the high individual surtax rates, and the corporate tax rates, on the growth creating investment process. We have also made a start toward dealing with the problems of poverty. One important future concern is the impact of the individual income tax in the lower, and lower middle, income brackets.

Over the years, if the income tax law does not change, the effective rate of tax at the average income level tends to rise, essentially because the personal exemptions become lower relative to the average income itself. This increasing effective tax rate shows up clearly at the low and middle income levels.

It is instructive to follow the experience of a family with two children that has every year an adjusted gross income equal to the average income of all American families. In 1950 this family paid an effective income tax rate of 6.7 percent. In 1960 the effective income tax rate on this family was 9.8 percent because of the increased average income. In 1965, we estimate that the rate has been reduced to 8.6 percent, but it remains above the 1950 level. On the other hand, the same progression has not been evident from the top income taxpayers, largely because the taxpayers had larger personal deductions.

These considerations were one factor bearing upon our recent action to reduce excise taxes which were a regressive element in our tax structure. In the longer run they require that we be especially alert to finding efficient ways to reduce income taxes at lower income levels. The provision in the Revenue Act of 1964 for the minimum standard deduction was a breakthrough in providing a new method of lessening the tax burden of those who can least afford to carry it. Possible expansion of this and other methods deserves continuing study.

Another issue in the area of tax structure is presented by the impediments to the flow of capital and the unlike treatment of like income. This is a perennial problem that needs continued attention to preserve confidence in the justice of our tax system and efficiency and mobility of our capital markets.

Decisions on changing the level of tax rates will bring to the forefront many other questions of tax structure. It is quite obvious that "taxation for revenue only" is not a principle that is rigidly adhered to in the United States. We have assigned to our tax law the function of encouraging diversified activities. The difficulty here is that this multitude of specific objectives tends to conflict with the basic objective of raising an amount of revenue necessary for our overall fiscal policy in a way that is equitable between taxpayers. This conflict is the root of our continuing concern about the matter of income tax reform.

The pursuit of diverse objectives through the tax law has in practice meant that some of the particular objectives tend to receive rather cursory examination, without full and continuing analysis of the effectiveness of the provision is accomplishing the desired objective. Expenditure programs are subject to an annual and rather critical review during the appropriation process. This means review both within the committees and on the floor of the House and of the Senate.

On the other hand, the question of whether or not we get our moneys' worth from a particular incentive in the tax law is raised for discussion perhaps once a decade, and then is dropped if the matter is not carried forward by one committee. What is needed in our opinion to improve our tax laws is some quite hardheaded analysis of whether or not the various preferential tax provisions—in effect an indirect Government expenditure—are an efficient way of reaching the objectives that we want.

The process that I am referring to is not different from the program analysis that the Bureau of the Budget has been trying to develop in various areas of direct Government expenditure programs. It requires detailed hard work to specify what we are trying to do and to measure the degree and cost of accomplishment. Such analysis might well be applied to areas of the tax collection and administration process as well as to the substantive law itself. This kind of analysis calls for considerable cooperation with the business, professional, and academic communities, cooperation between various Government departments, and for a strengthened research and analytic capacity within the Treasury.

FLEXIBILITY

In conclusion, I would like to refer to the matter of flexibility in fiscal policy. Whether we are at full employment or on a path to full employment, we must be aware of the possibilities of unexpected developments in the private economy that would tend to stall the growth of income.

The Congress has demonstrated that it can act quickly on important fiscal legislation, as it did in passing an excise tax cut in 32 days, a new record.

The important thing here was a broad initial consensus on policy, aided in large measure by the decision of the Ways and Means Committee to hold hearings on the issue prior to a legislative proposal.

This committee might make an important contribution to this aspect of the fiscal policy problem by undertaking some studies of the kind of temporary changes that should be made in fiscal policy to deal with the unexpected. What role should be assigned to tax cuts or expenditure speedups when more expansion is needed? As to tax reduction, what form of tax reduction is most appropriate?

The problem of flexibility in fiscal policy brings home in a striking way the problem before this committee and before all the fiscal policymakers. The problems are not only tough but also in the future decisions will sometimes have to be made rapidly. The kind of constructive analysis that this committee is undertaking will help assure that these decisions will be soundly based.

Representative GRIFFITHS. Thank you very much, Mr. Barr.

Do I understand that in the Treasury Department, you do not have anyone who is studying the effects of any of these tax cuts or who is considering what kind of tax cut will next be considered?

Mr. BARR. Oh, no. We have a large section, the Office of Tax Analysis, in the Department of the Treasury under the Assistant Secretary for Taxation. They are engaged in a continual review and analysis of various alternatives that we could be using.

I wanted to emphasize, Madam Chairman, that while we can be engaging in these internal activities, and we are with a competent and we think a sizable staff, I still think public discussions are extremely useful in helping us to measure our internal accomplishments against the consensus that might be developing in the public area.

Representative GRIFFITHS. Then what did your group discover was the effect of the depreciation tax cut?

Mr. BARR. Of the depreciation tax cut?

Representative GRIFFITHS. Yes.

Mr. BARR. We believe, Madam Chairman, that the two key elements in the depreciation area—first the 7-percent investment credit, and secondly, the depreciation guidelines that were enacted—that were published in 1962, had and are having a very important impact on the continuing expansion of capital investment in the United States. It was apparent that in the 1950's this area of investment was lagging. It was apparent that our equipment was wearing out and was not being replaced. Since the enactment of the investment credit and the implementation of the depreciation guidelines, one of the strongest aspects of our economic picture and an aspect that continues strong, is the amount of money that is being invested in plants and equipment in the United States. We think the program has been highly successful.

Representative GRIFFITHS. But how do you base your belief? On what facts? How do you know that it wasn't the fact that the 1964 income tax reduction put more money in the pockets of consumers?

Mr. BARR. I would like to back up a little bit and say that it is always impossible to determine precisely where the impulse comes from when a corporate manager invests. Does it come from the push that he is getting from consumers, or does it come from his cash flow? Or does it come from the rate of profitability on the amount of the investment he is going to make?

Although there are studies in many of these areas, I for one have never been able to assign a quantitative factor to each of these elements in decisions.

Representative GRIFFITHS. But what is the Treasury doing to measure the effects of changes in taxes?

Mr. BARR. I don't believe it is possible to do so with absolute certainty, Madam Chairman. I will tell you what we did do.

Representative GRIFFITHS. What kind of analysis section do you have that studies this and what are the studies?

Mr. BARR. The tax analysis section of the Treasury, Madam Chairman, as I said. If we can review history, in 1961 we had a budget that was heavily oriented toward increasing military expenditure. We saw there wasn't room for much of a tax reduction, so we took the tax reduction that was available to us—namely, the investment credit—and moved in the investment area first. We did it because our analyses indicated that this was the one area that was lagging most in the U.S. economy.

The second attack we made was in the consumption area in 1964. I would like to suggest to you that if we hadn't moved on investment first, if we had moved on consumption ahead of investment, very possibly the United States would not have had the productive capacity to meet the increased consumption demands and we could be facing an inflationary period at this time rather than the era of rather steady prices that is characteristic of this expansion.

Representative GRIFFITHS. But isn't it also possible that if you had reduced the taxes paid by consumers and increased the demand, you might have increased borrowing by corporate concerns in the United States and thus not have been faced with the balance-of-payments problem that you were faced with?

Mr. BARR. That is an interesting hypothesis. It has been argued that increasing cash flows has made it possible for U.S. corporations to invest more abroad. I am not certain that it can be substantiated. It was an element that we had to take into consideration.

As you know, in this country today we can't make fiscal policy in a vacuum. We have to make it with all the international considerations of the balance of payments to be considered. This was a consideration, but we decided that our lag in investment was so seriously affecting our ability to compete in international markets that we would take the chance on some of the additional cash flow running

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out of the country and still move in the direction of increasing our productive capacity and our efficiency and our ability to meet increased demands without increased prices.

Representative GRIFFITHS. The point in which I am extremely interested is the facts and how you obtain the facts on which you are going to ask for the next tax reduction or increase. This is the job of the Treasury; isn't it?

Mr. BARR. I am not quite sure I understand you.

Representative GRIFFITHS. Who is going to make this decision? Well, who is checking through the investment credit and what it did? Who is checking on the 1964 income tax cut? Who is checking on the payroll tax increase? What is the effect of all these things and who is finding out the effect?

Mr. BARR. These subjects are under continual scrutiny and review.

Representative GRIFFITHS. By how many people?

Mr. BARR. If you will pardon me, we have Mr. Brannon of the Office of Tax Analysis.

How many people do you have in the Office of Tax Analysis?

Mr. BRANNON. About 50, altogether. About half are professional people.

Representative GRIFFITHS. And what is their method of survey?

Mr. BARR. Would you like to come forward, Mr. Brannon? May I introduce Mr. Gerard Brannon of the Office of Tax Analysis, U.S. Treasury, who is more competent to answer some of these technical questions on surveys than I. The only thing I can say is that we in the Treasury make certain that these studies are constantly underway and I can also indicate to you something that is a bit of a secret. We are asking for 20 more people for the section in the next budget.

Representative GRIFFITHS. You might get a lot of support if you can prove to us that you are doing something.

Mr. BARR. Mr. Brannon, see if you can prove that to the chairman and then we will refer it to the Bureau of the Budget.

Mr. BRANNON. Let me make a few specific comments on the question you raise.

In the first place, this matter of trying to explain how much investment response to improvements in rates of return compared to improvement in the size of the market is a matter that is very much in disagreement among professional economists. It has been particularly hard to analyze the effects of our recent tax legislation because we know that investment plans respond only slowly to either kind of a change. Businessmen have to redesign their whole expansion plans and usually there are lags of a year or two.

For example, the Department of Commerce has not yet come out with its final estimates of gross national product for the year 1964. We don't have the detailed income tax statistics on profits and individual incomes for 1964 as yet. So that making precise evaluations at this time is still very difficult.

In another direction, the Office of Tax Analysis has been working with groups of private economists in this matter of analyzing recent developments in business investment in relation to growth of markets and rate of profits. We participated in a large meeting in the Midwest about a month ago with a number of academic economists who are conducting research on this precise point. It was pretty clear at that meeting that there is still simply not enough information following the two recent tax cuts to give us a precise analysis beyond the point that Under Secretary Barr has made, that quite clearly the investment has moved ahead rather sharply in this period.

Representative GRIFFITHS. All right. Now, if you can't actually determine the effect of the tax cuts that have already been given, which group is trying to determine which tax cuts will be next given? And on what they are basing their analysis?

Mr. BARR. Madam Chairman, may I suggest that whether or not the measurement of these things is subject to complete accuracy, our record so far has been quite good. We indicated to the Congress the investment credit and depreciation guidelines would stimulate capital investment in the United States. It has. We were conservative in these estimates.

Representative GRIFFITHS. At least something has.

Mr. BARR. Something has. Whether this has or not, at least the figures indicate one of the strongest elements in our expansion has been the investment in plant and equipment. So the statistics bear out what we told you.

We also indicated that the tax cut of 1964 coupled with expenditure controls, would help this country move ahead and toward a posture of a better balance in our domestic accounts. I think this has been indicated by the fact that as early as January this year, we were estimating that our budgetary deficit would be $6.3 billion.

Yesterday the President announced it was going to be $3½ billion. I can say in all honesty that we did err. We made a mistake on the amount of money that we were going to collect from individuals. We were off a billion and a half dollars. We were too conservative.

Representative GRIFFITHS. Thank you. My 10 minutes are up.

Senator Proxmire?

Senator PROXMIRE. I think when you talk about the equity of the tax cut, you are most encouraging and I am delighted to see that the Treasury Department has an interest in assessing the equity of the tax structure and is deeply concerned with what has happened to the average taxpayer's burden over the last 10 or 15 years.

This is something that hasn't been discussed very much and it is good to have the Treasury Department come forward and explain their concern and interest in it.

I am also happy to see, although I think that the chairman has brought out the need for a more specific performance, the fact that you have an analysis of the effect of your so-called tax incentives and it is going on continuously.

I would like to ask you about another angle that seems to me ought to be at least considered in these hearings. The Chairman of the Federal Reserve Board, William Martin, made a very disturbing speech about 6 weeks or so ago in which he talked about disquieting similarities between 1965 and 1929. Most of us, of course, don't share his apprehension, but I think this is a good opportunity for us to find out why the Treasury in a very comprehensive statement on fiscal policy didn't meet at least some of Mr. Martin's arguments.

One point that he made as I understand it is that our private debt has increased very sharply over the last 10 years. As I look at the economic indicators, there are some figures here that seem to be somewhat alarming, even if related to gross national product and increased personal income, and so forth.

For example, I find that installment debt between 1955–65 increased more than a hundred percent, from $38 billion to $78 billion. There was a sharper increase by far than the GNP. And the increase in installment debt was much greater in the last 2 or 3 years than the preceding part of the decade. And this, of course, is a high-powered kind of debt that requires payments that are much bigger than the longer term debt.

I notice also that the mortgage debt increased from $88 billion to about $200 billion now, even more than a hundred percent increase. And that also has been racing ahead more rapidly in the last couple of months.

Now, in view of the fact that the people who owe the money are not also in many cases the people who have the increases in income, how do you feel about this situation? Do you think this is an element that should give us concern and what can we do about it?

Mr. BARR. Senator, before I answer your question, may I repeat what I said to Madam Chairman. We are currently engaged in a long, hair-pulling contest with the Director of the Bureau of the Budget about getting another 20 to 30 people in the Office of Tax Analysis. The Bureau of the Budget is currently engaged in what they call program analysis and we have to prove to them very conclusively that we need every dollar we are going to get.

Now, in answer to your question on the private debt, there has been a large increase in the amount of private debt contracted by American people. It has been especially large, as you pointed out, in the past 2 or 3 years. Obviously—as people go deeper into debt, it does restrict their opportunity for freer movement in the future.

Offsetting this has been a rather sizeable increase in the amount of disposable income of the American people. I think one way to look at it is a man, say, with $3,500 income and trying to support a wife and two children, I don't see how he can get in debt at all. It is going to take all his money to meet his current obligations.

If you go to the other end of the extreme, a man with a very, very large disposable income can spend a very high percentage of his income on debt retirement and service. So it is this in-between area. As the level of disposable income is increased in the United States the old benchmark might not necessarily apply. You have to have a new set of benchmarks. In the final analysis, I get back to this conclusion. This subject of increase of private debt has been a matter of concern in this great Republic since its first days. It is unique to this country because in most areas of the world, and Europe especially, the average citizen doesn't go into debt. Nobody is going to lend him any money.

In this country, from the very earliest days, as people moved westward, they had to go in debt to buy land, a mule, and seed corn to get started.

Debt has been a characteristic of the American economy since its early days, not associated with wealthy people but it has been associated with everyone.

The best advice I have ever had on this subject, Senator, was given me by the treasurer of one of the largest retail establishments in this country. He said in the final analysis the level of the debt the American people are willing to carry is dependent on their own good judgment and their own commensense. He indicated that a psychiatrist is better equipped than the Treasury to answer your question.

Senator PROXMIRE. Well, you see, what I am concerned about is the possibility—and I haven't seen statistics that completely corroborate this but I think they suggest—that a relatively small proportion of the people, far less than a majority, has most of the debt and, as I say, they are not the same people who have assets.

Mr. BARR. That is the problem.

Senator PROXMIRE. That is their inability to meet their obligations increases and as we get perhaps an end to the present expansion period which we can expect perhaps sometime, you might get a pyramiding bankruptcy situation. You might get many failures that would damage the economy most severely, and I wonder if there is any consideration as to the possibility of instituting any kind of credit controls or considering anything of this kind.

Now, one of the most moderate, modest proposals I think in this direction is the proposal of the vice chairman of this committee, Senator Douglas, with the truth-in-credit measure that would at least let people know what the interest they are really paying amounts to—on automobile installments, around 15 percent; mail-order houses, 18 percent; furniture store as high as 60 percent. I notice that by far the most dynamic and rapidly rising element in national income is net interest which was $8 billion in 1953 and is $28 billion today. At least this truth-in-credit would be some benefit.

But I am wondering if in addition to that since the Treasury has responsibility for recommending credit controls, at what point you think that something like this might be more seriously considered.

Mr. BARR. Of course, you could go back to the controls that were exercised by the Federal Reserve Board in wartime over the amount and terms of installment credit.

Before we would make any such recommendation, Senator, we would have to see a very steep rise in the delinquency rate. At the moment the delinquency rate on mortgages and installment credit, personal credit, is very, very good. We keep track of this and we talk with various people about their own experiences.

Just last week we asked the chairman of the board of one of the large automobile companies about the quality of the automobile loans held by his company. He said he thought they were excellent, in his opinion as good as they had ever been in the history of the company.

He went on to point out, however, that he couldn't answer about some of the newer areas, such as the "go now and pay later" area, but some of these areas concerned him. Some bankers will contend that the normal mortgage area seems to be in good shape, but they get concerned about the man who reduces his mortgage $2,000 and then goes to borrow $2,000 to buy a boat or something not associated with his house.

In direct answer to your question about any controls, we have no such recommendations in mind.

Senator PROXMIRE. My other question relates to—well, it is kind of a two-part question.

You seem to put a lot more emphasis on fiscal policy than monetary policy. It is beyond me as to why you put as much emphasis as you do on this. It would seem to me the two things ought to work together and there is no more reason to say we have to rely on fiscal policy because of balance of payments than to say we have to rely on monetary policy for that reason.

They both affect the balance of payments. They both affect the domestic economy. It would seem to me it is far more attractive and easy politically to cut taxes and increase expenditures than it is to reduce interest rates. But from the standpoint of economic theory and of economic performance, it would seem to me that your mix ought to emphasize monetary policy at least as much as fiscal policy.

Mr. BARR. I understand you, you are talking about monetary policy on the upside, not on the downside.

Senator PROXMIRE. You keep talking in your paper about extreme ease. I don't know anybody who advocates extreme ease. Maybe a few want to go back to the 1930's but there are not very many. No one I know in Congress advocates anything quite that extreme. We are simply talking about accompanying a tax cut with a corresponding monetary policy and accompanying an increase in expenditures with the same kind of monetary policy.

Mr. BARR. We do attempt to do it, but there are very definite restraints on this country because of the balance of payments. As I mentioned to you, I don't think we can assume that we are living in a vacuum. We are living in a world of international markets.

Senator PROXMIRE. There are the same restrictions on your fiscal policies, aren't there?

Mr. BARR. I agree. I think there are some of the same restrictions but to a lesser degree because they are not as directly or instantly relevant.

Let's look at the discount rate which is at 4 percent or regulation Q which is currently at 4½ percent. If they dropped the discount rate to 2 percent and regulation Q to 2½ percent and coupled this with a very relaxed credit policy I think you would see a tremendous outflow of funds from this country unless, of course, it were stopped by our current voluntary program of limiting lending abroad.

I think if lenders had this choice, if this free credit were available, they would just leave this country and go find higher markets.

So what we have attempted to do since 1961 is to gradually increase the short-term rate. That is the rates on 60-, 90-, 180-day, and under 1-year credits. These have gradually gone up so that at the moment they are a bit under 4 percent.

The people borrowing this sort of money are mostly business investors and people in the corporate area. On the other hand, we have tried to keep upward pressure from the long-term rates. You will see that the long-term rates on municipal bonds, on corporate bonds, on house mortgages, are about the same, or in some instances lower, than they were in 1961.

Senator PROXMIRE. You have reached just about the end of your——

Mr. BARR. We may be toward the end of the road on this flattening of the yield curve; yes.

Senator PROXMIRE. I am at the end of the road on my time.

Representative GRIFFITHS. Congressman Ellsworth?

Representative ELLSWORTH. Thank you very much, Madam Chairman.

Mr. Under Secretary, of course, it is always nice to be able to get together with you and I want to compliment you on your fine statement and say that for my part I have benefited from your exchanges with the other members of the committee this morning. I came here directly from a meeting with Secretary Rusk. It was an off-the-record meeting but I think I can say that as I came away from the meeting I had the feeling that down the road in the weeks and months ahead, we may be asked to spend more money, quite a bit more money, perhaps, in the southeast Asia area and yet we have been reading lately about the possibility of another tax cut, and so forth.

From your vantage point within the Treasury Department, have you been able to make any projections or guesses as to the magnitude of the increased dollar requirements on account of our southeast Asia involvement and make a judgment of how that might affect any tax cut, or are you prepared at this time to say anything about that?

Mr. BARR. I think it is only reasonable to assume, Congressman, that, as we move toward final decisions in December, this will have an important impact on whether or not the country can have another tax cut. It is going to have an impact not only on the tax cut, but the direction the rest of Government expenditures would take.

At this time, I personally believe that we have enough slack in the balance of this calendar year and in the first half of next year to say that we don't need any tax increases. But, since no one knows at this time if an expenditure increase in connection with Vietnam will be required—the President and Secretary of Defense will have to decide that—my opinion is just that. But from what I currently see, we have enough room to handle it in our current circumstances. It might, as you say, rule out the possibility of consideration of any tax cuts in 1966.

Representative ELLSWORTH. Thank you, very much.

The other day, a distinguished economist, Professor Saulnier, former Chairman of the Council of Economic Advisers, made a speech on the general subject of fiscal policy in which he said that in his opinion a large part of the expansion that we have experienced in the last 4 or 4½ years was due to a stable relationship between wages and prices and productivity.

Now, can taxation, fiscal policy, be used to influence or to fight changes in wages and prices that tend to be inflationary, and if so, how?

Mr. BARR. First of all, I would certainly agree with Professor Saulnier that the stability of our price level, especially the wholesale price level since 1958, has been an important factor in this continued expansion we have been having. Even more important than that, in some of the areas that concern us deeply, it has helped improve the competitive position of the United States in the world. It has helped us jump our exports in the last 4 years about $5 billion. This has been crucial to our efforts.

We have had the best record, I think as Professor Saulnier pointed out, of any other industrial country in the world. It is because prices have been steady. Actually the unit labor costs in manufacturing have not increased. They have actually gone down. I know of no other country that can claim this record.

Now as to the impact of fiscal policy on wages and prices, I mentioned one to the chairman. As we looked at the growth problem that was evident in the 1950's that we thought was unsatisfactory, the question arose as to where to attack. We attacked first in the investment area, to increase cash flows, to increase the incentive to invest. Then we attacked in the consumption area. We thought if we had done it the other way that we would have had consumption without an increase in capacity, so you would have increased demands pushing on the same capacity and the only thing that could give was higher prices.

So we moved it the other way. There are many people who disagree with this approach, but it has resulted in a very stable price level.

Now in the other areas of fiscal policy and wages we have what a lot of people don't approve of: the wage price guidelines that were enunciated by the Council of Economic Advisers. Many people object to these guidelines, but I think in an era when we are fighting balance of payments problems daily, fighting to keep our competitive position in the world, fighting to keep the dollar a reserve currency, that it is incumbent on this Government to at least indicate to the private economy what are the acceptable areas in which you can move, and, if you move past these, you are probably going to upset the pricing system in the country that has enabled us to get competitive.

I think it is a good policy.

Representative ELLSWORTH. Thank you very much. At one point in your statement you pointed out that over the years if the income tax law does not change, the effective rate of tax at the average income level tends to rise and you said that was because of the personal exemptions getting lower relative to the average income itself.

This morning I read in the paper—I don't remember which one—something about the possibility of an increase of a hundred or two hundred in the personal exemption as a proposal that—I don't remember if it said it was under active consideration over at the Treasury or not, but is it?

Mr. BARR. I think the statement originated from Chairman Ackley, who raised this as a consideration yesterday. It is one thing under consideration. We are looking at many other areas. We had the minimum standard deduction. We are looking at that. We are looking at personal exemptions. We are looking at rates. We are looking at the whole area so we will be prepared to make our recommendations if the occasion presents itself.

I want to emphasize, Congressman Ellsworth, this is only one of a range of proposals that we have under consideration.

Representative ELLSWORTH. I understand. Thank you, very much.

Now also in your statement, when you speak about flexibility, were you talking there about a proposal that was circulated under the aegis of the CED several months ago about the possibility of giving the executive branch power to cut and increase taxes?

Mr. BARR. I was referring obliquely to that, but only very obliquely, because the Congress and the two taxing committees of the Congress, the House Ways and Means Committee and Senate Finance Committee, have indicated very strongly to us that they are not going to give the President authority to vary tax rates. Possibly, if I were still in Congress I would agree with them. It does smack a bit of the abrogation of power.

Along this line I mentioned earlier that the Congress passed the Excise Tax Reduction Act in 32 days. There are occasions when you just don't have much time—you can't dillydally. You have to get moving or the recessionary effect starts snowballing and the revenue losses could be enormous.

What I was indicating is that I think it would be appropriate for this committee, and for the Congress, to consider toward the end of every session, what they would do if you have recessionary tendencies developing, how they would go about meeting it, and how they could meet it quickly so you could develop a consensus—so that the opportunities would be there for the Congress to move quickly.

Normally tax reduction takes a long time, as Mrs. Griffiths knows. It is usually a year to a year and a half process. Well, that is useful in attacking a long-term problem but it might not be too useful in attacking a problem such as occurred in the fall of 1957, and faced the country right in the first months of the year in 1958. At that time it would be useful if the Congress could make up its mind as to what it wanted to do and do it quickly.

Representative ELLSWORTH. Thank you very much.

Thank you very much, Madam Chairman.

Representative GRIFFITHS. I would like to ask you if the Vietnam situation continues or if inflation begins, do you plan on reinstituting the excise tax?

Mr. BARR. We have no such plans, Madam Chairman. I have indicated to you that all we know about Vietnam now indicates two things. There is enough capacity so that there will not be pressures on inflation. This is a cursory look. There is enough taxing power so there would not have to be an increase in taxes. That is what we know at this moment.

Representative GRIFFITHS. Is it the general belief of the Treasury that taxes are too high?

Mr. BARR. It is the general belief, as I indicated, that they might be too high in the lower middle and lower income brackets.

Representative GRIFFITHS. Under these circumstances why did you ask that the payroll tax be increased next year?

Mr. BARR. Might I suggest, Madam Chairman, this was an administration proposal in which we concurred. It had to do with what we thought was a broad social objective.

Representative GRIFFITHS. It hits most heavily upon the lowest level; does it not?

Mr. BARR. Yes, ma'am.

Representative GRIFFITHS. And is this one of the reasons why you contemplate reducing income taxes at that level?

Mr. BARR. That is definitely one of the reasons. Yes.

Representative GRIFFITHS. Well, I am very interested in your suggestions for reform of the tax structure. Are you planning on asking for a tax decrease plus reform?

Mr. BARR. Our plans are not firm yet, Madam Chairman; I think it would depend. As you know from your experience on ways and means, in the case of reforms you have to let the people affected testify. What is reform to us might be bitter injustice to the person who is getting reformed. It takes a long time to examine.

I personally, as I have indicated, think that we must keep under constant scrutiny the whole tax structure to make sure that like income gets a like tax. We don't want to have impediments in the tax structure to an orderly capital market. These are two of the crucial areas.

Representative GRIFFITHS. Under those circumstances do you consider closing the loopholes or opening equitable loopholes for others?

Mr. BARR. As I indicated to you in another part of my statement, the tax system of the United States has obviously not been designed for revenue only. Through the tax system we accomplish a lot of objectives. Charity is one. Home ownership is another. The treatment of elderly is another. All these things and more. We try in part to get to our social objectives through the tax code. I indicated that I am not going to quarrel with this national opinion, but I also indicated that if you are going to consider these incentives as a Government expenditure, which they are in effect, maybe they should be treated the way Congress ordinarily treats expenditures. Look at them every year and scrutinize them.

Look at everything. I don't think anything is sacred. Homeownership, the elderly, the blind. Nobody should be sacred.

Every year, or periodically at least, I would think the Congress should take a hardheaded look at all the incentives that are built into our tax code and determine if this is the right way to get at the particular problem. Maybe it is, maybe it isn't. But as you know, there is a tendency for the Congress to write an incentive into the tax code and then maybe never look at it again for 10 years.

Representative GRIFFITHS. Yes, I am aware.

Are you going to present to this session of Congress a proposal for an antirecession tax rate cut?

Mr. BARR. This, Madam Chairman, we will not know until December.

Representative GRIFFITHS. Who is considering it?

Mr. BARR. Of course, it will have to go right to the President. The President has already started his budgetary hearings. He has had representations of the whole Government in. We went in will several other departments last Friday. The other half went in on Thursday.

The President is starting on the project of holding the levels of expenditures down. He has involved himself in that. He is looking at the expenditure side now. On the revenue side, after the expenditures have been set, after the Vietnam decisions have been taken, then he will ask us, I assume, the Bureau of the Budget, and the Council of Economic Advisers whether or not in light of the expenditure decisions that he has arrived at, what tax proposals would be appropriate, if any.

Now, I don't think, Madam Chairman, that we will know that until December.

Representative GRIFFITHS. The thing I am really interested in is on what facts are you going to base your proposals? Who is checking it?

Mr. BARR. We are checking it and there are several facts. Some of them we know right now. You mentioned the payroll tax. There is going to be a $5 billion drag in the first 6 months of 1966 from the increased social security tax. That is $5 billion you have to look at. Offsetting that $5 billion there is a $1,750 million in the second stage of the excise tax reduction. So there is an offset, but not completely.

Representative GRIFFITHS. Does it go to the same people and you——

Mr. BARR. It might.

Representative GRIFFITHS. And you don't yet know that that excise tax reduction is being passed on.

Mr. BARR. That is true.

Representative GRIFFITHS. How do you have checks on that?

Mr. BARR. We are checking it with the Bureau of Labor Statistics and the Council of Economic Advisers. We are running a very intensive check on the excise tax as to whether or not it is being passed through. You will notice the President is constantly exhorting American business to pass it on, too.

Now, I mentioned two offsetting factors. Those are two. The other factor is what is happening to the economy at the moment. I can give you some things that I think look good.

Representative GRIFFITHS. All right. What?

Mr. BARR. Capital expenditures look very good.

Senator Proxmire indicated the fact that installment buying is very high. Well, in the short run that is good because it is stimulating demand. There is an indication that housing starts have quit going down and are at last going sideways. The unemployment rate is at 4.7.

Another indicator, you never know how to take it but it is an indicator, is that the stock market has started back up. It kicked off again yesterday on Vietnam reports, but it is up.

All these things are taken into account in an attempt to develop an economic prediction, before the final conclusions are made on the budget, as to what will be our economic performance for the year 1966.

Now, when you have what we know, what Congress has already done, and when we have the economic predictions, and when the President determines what the level of expenditures is going to be, and in this connection what the level of expenditures on Vietnam is going to be, then we can all make a judgment as to whether the level of economic expansion is adequate. We can make a judgment as to whether or not our revenues are there to meet our expenditures. And in this context we will come forward with any recommendations affecting a further tax cut. But with the imponderables that we still see ahead of us, I would be very reluctant to say.

Representative GRIFFITHS. Are you contemplating the type of recommendation now that you will make no matter what the circumstances.

Mr. BARR. We are contemplating a range of alternatives, a whole range of them. Let me postulate a set of circumstances, if I may, Madam Chairman.

If it looks like the Vietnam expenditures will be small, any increases will be extremely small. If it looks as though there will be a drag on the economy next year—an unsupportable drag by the payroll taxes—if it looks as though the second stage excise tax cut would not be passed through, if it looked as though the whole economy was trending downward, we might consider at that juncture a shortrun tax cut. We might consider a longer run tax cut. We could move, as Congressman Ellsworth indicated, and as Chairman Ackley indicated yesterday, in the area of exemptions. We can look again at the minimum standard deduction.

These are the type alternatives that we will have to tailor to the situation as we see it in December of this year, late December.

Representative GRIFFITHS. Thank you.

Mr. Widnall, we are happy to have you join us. We will be glad to have you ask some questions if you would like to.

Representative WIDNALL. Madam Chairman, I would like to defer questions to Mr. Ellsworth at this time while I have a chance to look over Mr. Barr's statement.

Representative GRIFFITHS. All right.

Representative WIDNALL. Incidentally, it is really fine to see our former colleague up here on the Hill again. I regret I wasn't able to come here before because of a committee conflict to hear the first part of your testimony.

Mr. BARR. Thank you.

Representative GRIFFITHS. Mr. Ellsworth.

Representative ELLSWORTH. Thank you very much, Madam Chairman.

Getting back to this question of personal exemptions, you know, there is a great deal of interest around here on Capitol Hill in the population problem. Legislation has been introduced to establish a couple or at least two Under Secretaries of various Cabinet departments to deal with population. And, of course, one of the aspects of the war on poverty that concerned everyone is the fact that a good many poverty-stricken families are also extremely large families.

Now, of course, present tax policies give very substantial tax benefits to large families and wouldn't it be undesirable to provide new tax incentives for larger families in any further tax legislation?

Mr. BARR. Congressman Ellsworth, that is a unique proposal. It is the first time I ever heard it. Mr. Brannon, I think you should make note that this is a potential argument against an increase in the personal exemption.

Of course, that is an argument. I might also add facetiously that I have 5 children and married off two daughters last year. I was convinced that any serious discussion of the personal exemption would only occur when it didn't mean as much to me.

The personal exemption does have not only these attributes that you mention, Congressman Ellsworth. It has several others that have to be seriously considered. Senator Douglas—who is not here—has, on various occasions, indicated that he thinks the tax law should apply broadly, that not many people should be exempted from the burden of the tax law. He thinks that the burden should be very, very light on the lower income people, but there should be a little burden. So you do have this school of opinion in the United States.

Incidentally, this opinion was also held by the late Senator LaFollette. It is a thesis that, no matter what your income, everyone should feel a little of the tax burden, not much, and it should go on up. So the idea of removing many people from the tax law is repugnant to some elements of the academic community, and to some elements of the Congress. So that is another factor to be considered.

It is also very expensive. But, as I pointed out, the exemption has not been changed for a long time and to be consistent, perhaps it should be increased again. That is an argument on the other side. I can assure you that this would—I would think that if we made this proposal, if I were to gage the attitude of the Congress, that this would be a very popular proposal because it is easily understood. It is not as complicated as some of the other proposals we occasionally come forward with.

Representative ELLSWORTH. Thank you, very much.

Now, referring to this idea that has been advanced over a period of years about sending some of the Federal income tax back to the States and local governments, first of all, is that idea under quite active consideration in the Treasury or elsewhere in the Government as you notice the rest of the Government from your vantage point in the Treasury, and also is it sound fiscal practice or what are the problems involved in requiring that money be raised at the level of Government where it is spent?

In other words, would you like to comment on that generally?

Mr. BARR. In answer to your first question, Congressman Ellsworth, this issue has been under consideration in the Government for about a year. It has not gone any further than the consideration stage.

You also raise what I think is possibly the hardest problem, and a problem that more appropriately should be addressed to a political scientist rather than the Treasury because it is connected with the responsibility and the power and autonomy of local governments.

I think you can take certain things as given. The United States can do a better job of collecting taxes than the States or local governments, and for one very simple reason, not because we have better people or pay higher salaries or anything else. I think the main reason is fairly simple, that it is hard to stop a dollar for tax collection in this country.

We are currently having trouble stopping that tax dollar at the borders of the United States. We have to chase it around the world. The bigger area you have in which to stop the tax dollar, the better chance you have to collect. Dollars are very mobile and this poses a problem. The smaller the taxing unit, the more difficult the problem gets. That is the reason I believe we can do a better job of collecting income taxes than most States.

In addition, there are other aspects of the question that the Congress would have to resolve. Should there be standards placed on contributions to the States? What should be the formula? Should there be a formula that it goes back on population? Should it be on the basis of State income; on the basis of poverty?

There is a whole gamut of problems that the people who live in a political atmosphere can determine about as well as we. As you can see, the issue is part of the whole question of how the Federal Government will aid State and local governments. These are just some of the problems.

I might call your attention to the one time the United States made outright grants, which was in 1837. We distributed the surplus to the States and were immediately faced with one of the worst recessions the country has ever had. I don't know whether history is indicative or not—and should hasten to add, this does not indicate my personal opinion on the matter.

Representative ELLSWORTH. You don't have any evidence to suggest there was a cause-and-effect relationship.

Mr. BARR. No, sir, I do not.

Representative ELLSWORTH. Now, in this general area, as you look at what is going on, income taxes coming down, payroll taxes going up, State and local taxes which for the most part are either real estate or sales taxes, they are going up, too, and all of this combines to make the whole revenue system less progressive. Is that desirable and do you at the Treasury take all of that into account when you give consideration to tax cuts and so forth?

Mr. BARR. We do take it into account. As to whether it is desirable or not, it does seem to be a fact of life and you do have this problem, Mr. Ellsworth. As the average level of American incomes goes up, as the country becomes more crowded, as people demand more services from the Government because they are services that the only way they can get the services is through collective investment through their government, perhaps this whole area of progressivity and regressivity is not quite as important as it used to be, say, 20, 30 years ago. This is a personal opinion. After all, Government expenditures particularly benefit low-income individuals. There are many ramifications of this question that the administration is looking into.

But you are quite correct, I think, in your statement, that as you describe the mix, Federal taxes going down, payroll taxes going up, State and local taxes going up, you do have a less progressive aspect to our total tax picture. And we do take it into account.

Representative ELLSWORTH. At the end I just want to say that I think maybe the most important thing you have said this morning, at least the most interesting thing from my point of view, is your suggestion that Congress take a real critical look at the tax structure on the basis of analyzing the merit of various preferences within the tax structure every year or at least far more often than we do.

I think that is—I fully agree with that. I think this is excellent. It has been a pleasure to have you here.

Mr. BARR. Thank you.

Representative GRIFFITHS. Mr. Widnall?

Representative WIDNALL. No questions.

Representative GRIFFITHS. I want to thank you, Mr. Barr, for being with us this morning. We are very pleased to have you and I would like to say that I think you are well aware that it will be almost impossible for the Ways and Means Committee to start taking these critical looks. We will look forward to Treasury exercising its responsibilities first of checking the effect of all these taxes and, finally, of coming up here with some suggestions on which one should be cut at the proper moment.

This committee will stand adjourned until tomorrow at 10 o'clock when Mr. Schultze, Director of the Bureau of the Budget, will be the witness.

(Whereupon, at 11:35 a.m., the subcommittee was adjourned, to reconvene at 10 a.m., Thursday, July 22, 1965.)

FISCAL POLICY ISSUES OF THE COMING DECADE

THURSDAY, JULY 22, 1965

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON FISCAL POLICY
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to recess, at 10 a.m., in room AE–1, U.S. Capitol Building, Hon. Martha W. Griffiths (chairman of the subcommittee) presiding.

Present: Representative Griffiths; Senators Proxmire and Miller.

Also present: James W. Knowles, executive director; John R. Stark, deputy director; Nelson D. McClung, economist; Gerald A. Pollack, economist; Donald A. Webster, minority economist; and Hamilton D .Gewehr, administrative clerk.

Representative GRIFFITHS. Gentlemen, it is 10 o'clock and we will begin.

I am very pleased to have you here, Mr. Schultze, and will be pleased to listen to your statement.

STATEMENT OF CHARLES L. SCHULTZE, DIRECTOR; ACCOMPANIED BY WILLIAM CAPRON, ASSISTANT DIRECTOR; AND WILLIAM ROSS, CHIEF, FISCAL ANALYSIS, OF THE BUREAU OF THE BUDGET

Mr. SCHULTZE. Thank you, Mrs. Griffiths. If you have no objection, I will read through this.

Representative GRIFFITHS. As you wish.

Mr. SCHULTZE. Fine. The holding of hearings on the subject of fiscal policy issues facing this Nation in the coming decade is especially useful in this 53d month of continuing expansion in economic activity. We need constant reminders—

That our economic successes are the result of careful and deliberate fiscal policy actions;

That while we have come far we still have unachieved goals to realize; and

That the very substance of the relationship between our tax system and the Nation's economic growth makes fiscal inaction positively dangerous.

Your committee's discussions make a valuable contribution to illuminating the alternatives open to us and the consequences of our choices among those alternatives. I am glad to have the opportunity to add my own perspective to what you have already accumulated through written submissions from private economists and from statements by my colleagues in the executive branch—the Chairman of the

Council of Economic Advisers, and the Under Secretary of the Treasury.

Chairman Ackley and Under Secretary Barr have already discussed the major aggregative and revenue aspects of our fiscal policy, our recent fiscal experience, and the related fiscal problems of the next decade as we now see them. I would like to underline briefly a few of the points they have made with respect to these overall issues. I think it might be of most assistance to the committee, however, if having done this, I spend the balance of my time discussing how decisions with respect to individual expenditure programs fit into an overall economic and fiscal framework.

This after all, is one of the major concerns of the Budget Bureau.

I do not need to spell out in detail before this committee the fiscal policy implications of the fact that our Federal revenues rise steadily with—if not faster than—GNP. At the present time, growth in the labor force and steadily rising productivity yield increases in the Nation's potential economic output of some $35 billion per year. On the basis of existing tax laws, a parallel rise in actual GNP would produce an added $7 billion in Federal revenues each year. Fiscal inaction—failure either to reduce tax rates or to raise expenditures—implies, therefore, a potential increase in the Federal budget surplus of 7 billion in 1 year, $14 billion in 2, and over $20 billion in 3. Under all but the most inflationary conditions, it is clear that the economy could not stand this burden, that the actual rate of economic growth would fall well below the potential growth rate, that a recession would very probably occur, and as a consequence, that the possible budgetary surplus would never in fact materialize.

In brief, the very nature of the tax/GNP relationship gives to fiscal inaction a highly deflationary impact. Fiscal neutrality does not, therefore, consist in doing nothing, since doing nothing turns out to be a very restrictive policy. We have no choice but to make fiscal policy choices.

Paradoxically, however, there is one respect in which this dynamic revenue/GNP relationship yields important fiscal flexibility. Built-in increases in tax collections provide us, automatically, with a revenue margin adequate (in most cases more than adequate) to deal with unforeseen new spending requirements—such as the Vietnam situation—without necessarily having to enact increases in tax rates. Unless the increases are quite extraordinary, this margin will be sufficient to cover the situation. And even when it is not, the revenue margin provides time to make a more careful evaluation of the fiscal situation, weighing the merits of tax increases against expenditure reductions in other areas.

We have given the label "fiscal drag" to the tendency of Federal fiscal system to take more from the economy than it puts back when spending consistently rises more slowly than revenues. Whether the results of "fiscal drag" are harmful or beneficial depends upon the strength of private spending and the levels of employment and output which prevail. This administration believes that the present state of the economy requires the effects of fiscal drag to be substantially moderated. But it is equally prepared to recognize and act in situations in which fiscal drag should be permitted to exert a brake—when economic stability is endangered by threatened overutilization of plant or the work force.

In any event, fiscal drag can be influenced through changes in either the tax or spending side of the equation. Careful fiscal action will seldom permit exclusive concentration on one or the other.

From an overall fiscal policy standpoint—and I underline overall—what is important is the aggregate size of expenditure increases compared to the magnitude of revenue increases. But in moderating or eliminating the fiscal drag, it would be gross fallacy to choose between expenditure increases and tax reductions simply by reference to some "desirable" overall rate of expenditure increases. Federal spending per se is not an objective of our economy or our fiscal policy. We spend for some purpose—to provide directly an item or service which meets national objectives, to meet past obligations, or to augment private or State and local spending in desired directions. But each expenditure program must be judged on its own merits, and against the desirability of providing more leeway for tax reductions. Inevitably, therefore, any conscientious decision about the relative merits of expenditure increases versus tax cuts must flow from an analysis of the benefits of individual programs relative to their costs—the decision cannot be made in the abstract by reference to some rule of thumb about the "needed" rate of increase in total Federal spending.

This proposition can be carried further. A judgment about aggregate expenditure increases cannot be made solely by an inventory and analysis of proposed new programs—however careful and prudent that analysis is.

The changing conditions and circumstances which give rise to the need for new programs also call for periodic reexamination of existing ones. Aggregate budgetary totals, therefore, can only be validly determined after careful and individual review of both old and new programs. Clearly, as this Nation grows, total Federal expenditures will grow. We cannot meet the challenges of the coming decade with an unchanged level of Federal expenditures. But there is no neat relationship between these two rates of growth.

What I have been talking about is well illustrated by the budgetary history of the past several years. On the basis of the budget presented to the Congress last January, we expect total budget expenditures to rise by $2 billion between ficsal years 1964 and 1966—from $97.7 to $99.7 billion. Yet within this $2 billion increase, total expenditures on programs closely allied to the President's Great Society concept—in the areas of health, education, housing, community development, manpower training, and antipoverty efforts—will rise by $4.3 billion, representing a 64-percent increase. Expenditure reductions in other areas make room for more than half of the increase in the major new programs. Events in Vietnam have overrun this forecast. Military spending will clearly be higher than the President estimated in January.

But this does not invalidate the basic point—that it makes no sense to talk in terms of an aggregate expenditure choice—that the total level of expenditures should be judged on the basis of individual programs merits, taking into account both desirable new programs or program expansions and a continuing review of spending on existing programs.

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INDIVIDUAL PROGRAM ANALYSIS

I would like to turn now to the specifics of program analysis, and discuss with you some of the problems of budgetary decisionmaking as they will affect fiscal policy in the years ahead.

We will, in this decade, be called upon to make an enormous number of decisions as a nation to meet challenges imposed by our domestic development and our international position. These will be decisions to recognize or ignore new needs; decisions to abandon, enlarge, or revise old activities; decisions to modernize and make more efficient the means for carrying out Federal programs; decisions to act individually or collectively through private or public instrumentalities; and decisions to act through one or another—or more than one—of the levels of government which make up our American Federal system. Federal spending levels will be determined almost wholly as a byproduct of these decisions. Both the quality of our national life and the productivity of the economy will be determined in large part by the efficiency of these decisions. Overall fiscal policy can help us achieve full employment. But the level of national output and national welfare we achieve, when at full employment, will depend in an important way upon how well we make individual program decisions about Federal spending. We can misuse our national resources—

By failing to employ Federal spending in areas where it can best achieve important national purposes; and

On the other side of the coin, by using resources in the Federal sector inefficiently or to keep obsolete and low priority programs intact.

The quality of the budgetary decisionmaking process in the Federal Government is, therefore, a big element in overall fiscal strategy. How wisely the choice between tax cuts and expenditure increases is made depends upon how well the Government is geared to making intelligently the thousands of individual program choices which arise each year.

The efficient allocation of resources in the Federal sector of the economy requires two kinds of choices: first, a choice of the least-cost method of carrying on a given program—in other words, cost reduction; second, a choice of where to allocate budgetary resources among the many competing claims of existing and proposed new programs—we might best describe this as program evaluation.

In the most fundamental sense, these are not two different approaches to the decisionmaking process. Whether a particular action is labeled "cost reduction" or "program evaluation" depends heavily on the viewpoint of the observer. For example, in supplying our troops abroad in the event of war, we must make decisions about the proper mix of airlift, sealift, and overseas prepositioning of equipment. We want to achieve the desired level of supply capability with minimum budgetary impact. From one viewpoint, say that of the Secretary of Defense, this could be called a cost reduction program—how to achieve the necessary supply effectiveness at least cost. To the various armed services involved, this might appear to involve a program evaluation decision—a choice among aircraft, ship, and floating depot procurement programs.

Even though the two aspects of efficient resource allocation in the Federal sector—"cost reduction" and "program evaluation"—are closely related, we can and have distinguished between them in our approach to this problem. We have undertaken, and are continuing to develop, steps to build into the Federal establishment the institutions and the analytic capacity for continuous application of both of these concepts.

Before this committee, I would like to concentrate on the problem of program evaluation. This is not because I believe that cost-reduction programs are unimportant. You are all familiar with Secretary McNamara's cost-reduction program and the billions which it has made available both for tax reduction and for financing other programs. And in March of this year, the Bureau of the Budget, at the President's direction, issued instructions to other agencies to set up a similar formal program in their own operations. Yet, in the long run the major questions of efficient resource allocation are going to revolve around program decisions—the evaluation of and choice among alternative programs.

The problem of the President, the Congress, and individual department heads in making the program decisions which go into a one hundred billion dollar budget is a staggering one. The total expenditures of the Federal Government, including the trust funds, equal the combined annual sales of the 45 largest U.S. corporations. In order for top policy officials to cope with the vast number of decisions involved and to be in a position to make rational choices, it is important that we improve the decisionmaking process. Our major need is much wider application of improved methods, techniques, and systems analysis applied to the definition of program objectives, the measurement of performance, and the weighing of alternatives as the basis for decisions.

The first and most difficult of these tasks is defining program objectives in specific terms capable of being analyzed. Not only must they be specific, they must be associated with definite time periods within which the objectives are to be accomplished. The programs of the Federal Government, after all, have an "output." They result in something being accomplished in a given timespan—providing a given type of military capability, or helping to educate a specific number of children each year, or providing a particular set of recreational opportunities, and so on. Too often, budgetary decisions are made in terms of the level of support for an organizational unit or the quantity of inputs purchased. But in order to make intelligent budget choices we really want to be able to analyze the output of a program and compare what we get for what we have to pay. To do this, we need to be quite specific about program objectives. While quantification is always desirable, we can miss the real sense of many Government undertakings if we confine our attention to quantifiable dollars and cents kinds of measures. What we need is a more careful analysis of our objectives throughout the full range of governmental activities, not only in defense, where much work has been done, but also in the poverty program, in transportation, in education, in health, in the conduct of foreign affairs, and yes, even in the administration of justice. We are making a start in these and other areas.

To do a good job in most of these areas we will have to go beyond formulating our objectives more clearly and analytically. We will also have to develop "indicators" that tell us how well—or poorly—we are doing. In short, we need measures of effectiveness. It would be extraordinarily naive to suggest that we can get simple measures that can tell us how we are doing in education or health or foreign policy, for our objectives in these fields are complex. But we can develop measures of effectiveness that are not only useful but, I would submit, essential if we are to understand how our programs contribute to our objectives. And it is not beyond our ability to measure the performance of important aspects of our highway system, or our educational system, or our foreign aid program. To what extent does each different type of training within our manpower training program contribute to a reduction in unemployment and an increase in productivity, and how do each of them compare in relation to the costs of training? What values—of timber, recreation, and soil quality—are enhanced by the forest fire preventive activities of the Forest Service? Can we determine the effectiveness of a dollar spent on bringing students to the United States under the cultural exchange program compared to the effectiveness of assisting those who are coming in in any event under private auspices? We do much of this now in Government simply as a matter of good management. But we can and we must do it more systematically and better.

We must not stop at this point for there is an additional crucial step in this process. It is the development and comparison of alternative ways of doing the job. We need to examine and reexamine existing programs as well as new ones and look for different and better alternatives. In some cases, programs have endured for many years—long after their original purpose has changed, sometimes without administrators realizing it. This process of examining alternatives may lead to a better job being done, or it may lead to cost savings. Sometimes, with luck, it leads to both.

I think you will agree that this kind of analysis cannot be sensibly carried out on a short term, ad hoc basis, rushing to meet budget deadlines. Instead, it calls for a continuing effort to study our existing and proposed programs in the needed depth. We need to deepen our understanding about objectives and measures of effectiveness and to develop increasingly better alternatives over time. To do this requires that we have highly qualified people in our program evaluation staffs throughout the Government, and I am pleased to note that in several agencies we do indeed have some outstanding people carrying out these tasks.

I don't want to leave the impression that this approach is particularly complicated or esoteric. Still less do I want to suggest that "computers" are going to take over. Nothing could be further from the truth. The subject matter we deal with is too complex and too uncertain to be capable of much useful analysis by computers. On the contrary, the use of better and more systematic methods of analysis in government can do much to strengthen the hand of our top political leadership. At present, problems often come up for decision at the highest political levels in a form which prevents the making of sensible choices or at least makes those choices very difficult. The objectives may be unclear, the contribution of particular programs to these objectives obscure, the costs highly uncertain, and most commonly the relevant alternatives missing. The analytic approach I have been discussing could do much to define problems in ways much more useful to the President and the Congress than is now often the case.

While few domestic agencies have yet inaugurated the full range of program analyses and budgetary planning associated with the names McNamara, Hitch, and Enthoven, it is a mistake to think that the Bureau of the Budget and civilian departments and agencies have never attempted cost-benefit or cost-effectiveness analysis. Today, in many agencies, we find examples of attempts to apply the notion of "return on investment." For example, the Internal Revenue Service insists on a "payoff" ratio of at least 6 to 1 in the return on any added investment of resources in tax audit and collection activity. In developing and justifying the application of the user-charge principle to various types of Federal activity, some analyses have been made which are a version of what I would call a "return on investment" approach.

Moreover, the budget process itself requires the Bureau of the Budget, at least implicitly, to undertake a kind of "cost benefit" or "program" analysis in arriving at the recommendations it makes to the President with regard to Federal expenditures. What the Bureau is now embarking on is, therefore, properly regarded as a further evolution and refinement of a central part of its undertaking. What we hope to do, in close cooperation with the departments and agencies of the Federal Establishment, is to apply a more systematic and continuing process to the decisionmaking task faced by the most bureaucratically submerged section chief, all the way up to the Presidency. In this undertaking, we will apply and adapt where possible many of the techniques and approaches which have proved fruitful to date, primarily in defense applications.

In summary, our goal is to improve the present budgetary process in order to make available to department heads, the President, and the Congress a crisp and specific analysis of program objectives and accomplishments measured against costs. With this background, proposed program changes can be evaluated quite explicitly in terms of services rendered and results achieved. And all of this must be in a form which makes it possible for policy officials to see quite clearly the consequences of their choices in terms of governmental effectiveness and budgetary costs.

It is these choices, also, which will largely determine the fiscal policy issues involved in the question of tax cuts versus expenditure increases.

We have, I believe, come a long way from the unbalanced view that the only sound fiscal policy was a balanced budget every year, regardless of the state of the economy. The administration, the Congress, and the public now look upon fiscal policy as a powerful means of helping the Nation achieve full employment and rapid growth, and—when the circumstances warrant—an equally powerful means to damp down inflationary demands by running a surplus. Your committee has played a singularly important role in this process, as I am confident future economic historians will attest.

As we have made progress in this direction, a new obligation has been placed upon us.

If each change in expenditures is no longer to be matched by an exactly equal change in taxes, we must provide an alternative mechanism for insuring that spending decisions are under careful control. We have freed fiscal policy from an arbitrary constraint. But constraints on expenditures we must have. It is incumbent upon us to provide rational ones. This is the primary goal of the major efforts toward careful and continuous program evaluation which I have described. It is the basic thrust underlying the President's budgetary strategy during the past 2 years. A "new" approach to expenditure evaluation is, I am convinced, a necessary corollary to the "new" fiscal policy.

Thank you.

Representative GRIFFITHS. Thank you very much.

You made an excellent statement. We appreciate it greatly.

Now, I would like to ask you, suppose you set up the budget for this year. You believe that we are not going to have fiscal drag. You have set the budget for that. Outside of Vietnam, what are some of the factors that could upset your calculations?

Mr. SCHULTZE. Well, I think, of course, the major factor that could upset a calculation with any budget is that economic events move substantially differently from those that were anticipated when the budget was set up.

Representative GRIFFITHS. That is, the consumer wouldn't buy, the investor wouldn't invest. Are those the things you are suggesting?

Mr. SCHULTZE. That is one direction, in other words——

Representative GRIFFITHS. What other things? Specifically what other things?

Mr. SCHULTZE. Well, if I may keep general for the moment, there are two kinds of things which could happen. One is that we would err in being too optimistic and as you indicated, the ratio of consumption to income would fall off so consumers spend less or investors don't purchase as much investment, or inventory accumulation is substantially smaller than we have had anticipated.

The other side of the coin, obviously is that it could work in the other direction. We could do too much. Instead of being faced with too much fiscal drag we would want to increase the fiscal drag somewhat.

Representative GRIFFITHS. What are your alternate plans and how do you make them?

Mr. SCHULTZE. Well, there are two points. One, under conditions in which the balance of payments was somewhat easier than it now is, we could use monetary policy much more freely than we are now able to. Granted the balance-of-payments situation, we are somewhat restrained in how far we can use monetary policy—not locked in but somewhat restrained. With respect to fiscal policy we have the following kinds of options:

One, so long as Congress is in session and if events move in the direction that appears indicated, the President may ask the Congress either for supplemental appropriations for new expenditure programs or for tax cuts.

Secondly, this leaves, then, depending on the specific situation of the year, perhaps a 4- or 5-month hiatus—in some recent years it has been much less than that—when the Congress is out of session, during which time there is some flexibility in speeding up expenditures by the Federal Government if necessary for this—but quite frankly, not much flexibility.

Representative GRIFFITHS. But some flexibility also for stopping Federal expenditures.

Mr. SCHULTZE. On the other side. I guess if I had to give you a quick answer, there is probably somewhat more flexibility in pulling a tight rein on expenditures than there is on speeding them up.

Representative GRIFFITHS. Do you have programs planned that could be put into immediate effect or that you would ask for immediately? Do you consider these things or not?

Mr. SCHULTZE. Well, yes, we are now, as a matter of fact, working—and I want this to be carefully understood—we are working on taking a careful look at the kind of programs which could be speeded up or slowed down to determine more carefully than we have in the past what kinds of administrative flexibility we do have with respect to programs.

I don't want to mislead you. My own view is that in the very short run, while there is some flexibility, it is not huge. It takes time to get most desirable expenditure programs going. It takes time to accelerate or to slow down ongoing expenditure programs.

Representative GRIFFITHS. Do you have any historical surveys of how long it takes to put any program into effect?

Mr. SCHULTZE. Well, let me see. We do, for example, have information—fairly complete and quite complex information—on the expected time of initiating and completing various construction projects, as a case in point. I don't mean that we have a formal table that you can take a look at and very easily put your finger on cells in the table with the data on timing. But we do have a good bit of background data accumulated over the years which can be dug out in terms of specific kinds of construction programs, and can tell us how long they take to get started.

Representative GRIFFITHS. A construction program would, I would assume, be one of the slower ones to put into effect; isn't it?

Mr. SCHULTZE. Most of them, yes. There are smaller numbers of relatively quick starting ones but I must admit they are relativelv small in number.

Representative GRIFFITHS. What is the most rapid way in which you can put money in circulation—that is, spend money?

Mr. SCHULTZE. Well, now, without passing any new laws, in other words, under existing conditions——

Representative GRIFFITHS. The most rapid program in which you could react the most quickly.

Mr. SCHULTZE. Let me see if I can do it this way. On the one hand, the most rapid way you can get money into circulation is through the various direct transfer type programs where you are simply passing checks out—relief, public assistance, this sort of thing.

Representative GRIFFITHS. Extending unemployment compensation?

Mr. SCHULTZE. That is right, extending unemployment compensation. This, of course, works automatically as unemployment goes up and down.

The second, most rapid way, probably relates to the kind of programs we now have in many areas with regard to the poverty program where you have individuals in training on work projects; with some limitations, you can expand or contract these. These still take time. We have to plan them, but this can be done. In that second category I would probably also put a relatively modest number of small construction projects which you can get started fairly quickly.

The third would be, I think, when we get into the long leadtime items of major purchases of equipment or heavy construction.

Now, our flexibility under all of these in turn will vary if I switch from this kind of physical categories to legal categories where it depends on the kind of appropriations we have and the kind of legislative authority we have. So, for example, just handing a check to a person on relief, increasing the size of that check, or increasing the amount of unemployment compensation is something that gets into the economy immediately, but on the other hand, we have very little flexibility in making such changes. In fact, as far as I know, practically none.

Representative GRIFFITHS. Personally I would like to see an experiment, that I don't think we are going to see, of a tax cut where you actually give a substantial sum of money back to people as opposed to a tax cut where everybody gets a small amount monthly. I think the effects of a large tax cut where you give money back would be that they would buy larger items. I think it might be also that they would go into debt more, which I think increases the expenditures anyhow. So that there would be something to be said for comparing the type of tax cut.

Mr. SCHULTZE. Well, let's break that into two parts. If you are thinking about to whom could you give the tax cut—where it would do the most good from kind of a social welfare standpoint, who needs it the most—I think you are right. I think you are probably right with respect to the general thrust in terms of how rapidly it would be spent. But I don't think I would push that too far for two reasons.

First, from the point of view of the overall economy, I don't think it really makes a lot of difference whether they spend the money for big ticket items or an equivalent amount of dollars on small items.

Representative GRIFFITHS. Not necessarily. I think not, either. But if I were a seller of refrigerators I would want them all to get a hundred dollars or two hundred dollars back at one time.

Mr. SCHULTZE. Yes; on the other hand, if I were the seller of sundries—and both of us employ people——

Representative GRIFFITHS. Yes, but it does make a difference.

Mr. SCHULTZE. Yes.

Representative GRIFFITHS. Now I would like to ask you—where you point out that you need to develop indicators that tell us how well or poorly we are doing, that we need measures of effectiveness. What are you doing toward developing those?

Mr. SCHULTZE. Well, we are doing two things, both really along the same lines, one somewhat more intensive than the other. First, I am now meeting—well, this is an annual process on the part of the Budget Bureau—I am meeting with every department head during the summer after having examined their submission of their forward program plans and the major issues as they see them in the coming year.

In those meetings I am stressing to each and every one of the Cabinet departments that I consider it to be an absolute necessity that they strengthen—where they have them—their program evaluation staff; where they do not have a central program evaluation staff directly reporting to the top man, that they establish one—precisely for purposes of getting at these sorts of things.

Representative GRIFFITHS. Will you give me an example of one thing where you are attempting to measure effectiveness in any department except the Defense Department?

Mr. SCHULTZE. I can give the best examples there.

Representative GRIFFITHS. I know, but I have heard them all.

Mr. SCHULTZE. For example, one of the most intriguing attempts that is going forward here is in the poverty program.

Mr. Shriver has taken on board Mr. Joseph Kershaw who is former provost of Williams College, formerly with the Rand Corp., and a well-known economist—precisely to do the kind of things I have indicated.

For example, under the poverty program we have two specific approaches to teenagers—youth, young people. One is the Job Corps which is really a residential operation where they actually go into the camp. The other is a Neighborhood Youth Corps where they don't go to camps, but are employed and trained on projects in the home town.

The Job Corps per person taken in costs a lot more. On the other hand, presumably it is somewhat more effective because you get it 24 hours a day, really. You take people out of the old environment.

You want to ask yourself the question, given limited resources—and resources on anything are always limited—how do you get at, how do you measure the benefits—sociological and economic—in terms of increasing training and productivity, employability—these kinds of things?

How do you get at these? How do you measure them, and then can you compare the benefits from them to the cost?

This doesn't mean you end up with an all-or-nothing solution. In most cases you don't, but it is a question of relative program emphasis.

This program office will look not merely at these two approaches, but will look across the board at antipoverty programs. They will also look at how the programs of other Government agencies interrelate with what they are doing in terms of measuring effectiveness. Kershaw and Shriver have said repeatedly that their interest is not primarily or even at all in maximizing, if you will, the program of the Office of Economic Opportunity, but in maximizing the total Government efforts and the effectiveness of the Government's efforts in poverty; hence, they are looking at programs of other agencies to see how they interrelate as they affect the poor.

Another area where slow, tough work is going on is in the Federal Aviation Agency. How do you measure the effectiveness of our airway systems in terms of delays?

There are terminal delays, for example, depending on the nature of the equipment you have and the tower operators you have—how sophisticated your equipment is. I am not talking about safety at the moment. I am just talking about effectiveness in terms of preventing delays. What does it pay in the long run to put another $500 million in over the next 10 years compared to what you have at the present time? Would system X do better than Y?

How do you measure the importance of the delays? Do you get better results by putting funds into terminals or concentrating your efforts on enroute traffic control? This would also prevent delays.

These are two areas. It is a difficult, longrun process. It is going on. One of my major goals in life is going to be to try to intensify and speed it up.

In addition to making this point very strongly and impressing on each department and agency the desirability and necessity of doing this, the Bureau of the Budget itself is setting up a small shop whose primary aim will be to provide a kind of core of technical assistance to the departments and agencies in pushing in this direction. We are trying to get what we call, for want of a better term, a little "brain barn" which hopefully we would use precisely for this purpose.

Now in some areas, this has been going on for a long time. In the water resources field, for example, cost analysis is going on now. This can be improved also, but it has been done there.

Representative GRIFFITHS. Senator Miller?

Senator MILLER. Thank you, Madam Chairman.

Mr. Schultze, how would we or how should we evaluate the success or the failure of a budget? Are there any particular criteria that you would pinpoint for us?

Mr. SCHULTZE. That is a tough one, Senator. I would have to do it in two directions, I think. One would be an evaluation of the budget as it affected the overall economic prosperity, growth, price stability, everything else in the Nation—the overall impact of fiscal policy. How well has this budget contributed toward our national economic goals? This is not easy, but it is much easier than the second one I am going to have to discuss in order to answer your question which goes to precisely what I have just been talking about. How well and efficiently do the individual programs on the expenditure side of the budget (*a*) accomplish the Nation's objectives and (*b*) at a minimum possible cost.

Now, I insist there is no way of taking a look in that context at an overall budget and saying it is good or bad. Quite frankly, the existing budget has a lot of good parts and, I will have to admit, some bad parts. Clearly, we can do better in certain areas.

Senator MILLER. In respect to the first one in which you measure the success or failure against the overall economic objectives of the Nation, I presume the economic objectives that you are referring to would include employment?

Mr. SCHULTZE. Correct.

Senator MILLER. It would include stability of the purchasing power of our dollar?

Mr. SCHULTZE. Correct.

Senator MILLER. Or the degree to which we have had inflation?

Mr. SCHULTZE. Right.

Senator MILLER. And I suppose foreign trade and productivity?

Mr. SCHULTZE. Correct. Economic growth.

Senator MILLER. Well, now, if that is so, in your statement you pointed out some of the things that you can do for the Congress by pointing up how these various programs would contribute to the objectives. I wish you had added in there recommended priorities and timing or phasing in of programs. Can't you do that, too?

Mr. SCHULTZE. Yes, sir. I fully agree with you. In a way, what I have been talking about is getting at priorities. For example, the way to get at priorities is to lay out the objectives of a given department carefully so that you can then look at your individual programs' and get a measure of priority by how well they are fulfilling the appropriate needs. You may find some areas in which you are overdoing the job. I would say that they are very low priority areas. You may find other areas where—when you are looking at these objectives and specified against performance—you are far from getting where you ought to go. This is a high priority area. Even though I have not used the term "priority" here, we have used it in our dealings with the agencies and specifically asked them to come in with an assessment of priorities.

Senator MILLER. I think that is fine and I have had the feeling you have been doing that during the years and perhaps been doing a little more of that lately but I don't think that goes far enough. It seems to me not only should you do it with respect to the agencies but you should do it among the agencies when you come to Congress because there are certain programs that may fit into an agency and be deemed by that agency to be top priority but measured against the requirements of other agencies and the overall objectives of the budget, it may be a relatively low priority and should be shelved for a while.

Mr. SCHULTZE. Well, ideally, Senator—I underline ideally—we ought to be in a situation wherein the budget we send up, we have both subtracted and added so that in all areas any additional dollar would have the same priority. By that I means if, for example, it is true that in one area we have a program with a lot higher priorities than in another, then quite frankly that budget is not perfect because we should have reduced the programs with low priorities and raised the programs with high priorities to the point where the next additional dollar should have the same payoff.

Quite frankly, no budget is that ideal. We try to do that, and when we send a budget up—having attempted it—I don't think we are really in a position of saying, "Here is a budget, but honestly, this part of the budget isn't as important as that." Hopefully, we in working through the budgets have done as much of that type of analysis as we could. But, I must say I would find it a little difficult to go through such an analysis after we have sliced the agency requests and everything else and then say, "Having done that, we still haven't done a good job."

Senator MILLER. It might be difficult for you to do that but I do think it would be helpful. I don't need to tell you that you come over here with certain recommendations and the next thing you know the recommendations may be doubled by some action of Congress and it seems to me that the doubling or whatever action the Congress takes to go beyond your recommendations ought to be in the full face of a recommendation from you that if they should exceed this budget, then these are the areas of priority where they ought to be cutting.

Now ultimately it is for Congress to be deciding this question but I think they need some guidance. As it is now, I am afraid, they have no particular guidance and the next thing you know, your reccommendations are exceeded in some areas and they are not cut very much in others and the first thing you know, we end up with an unbalanced budget.

Mr. SCHULTZE. The only problem with that, in all candor, is that as a general proposition when the Congress appears to be about to give us a lot more than we want in certain areas, we normally do yell about it. We normally do make recomendations that this goes beyond the President's budget.

If at the same time having made those recommendations, we said, "Well, go ahead but if you are going to do this, cut somewhere else," the problem would be that the people who are making the increase aren't responsible for the area where it ought to be cut. It would look a little bit as if we are giving in here and kind of recommending that the Congress increase it over our estimate. I am afraid it would end up that the last state of the man would be worse than the first.

You may be right that it would work but I have some reservations about this.

Senator MILLER. Well, if you would implement your policy of saying if you are going to increase here, you are going to have that cut somewhere else by detailing the relative priorities of these cuts, for example, the relative priorities of the programs, especially new programs.

Mr. SCHULTZE. Well, to give you an alternative to that, we hope eventually—this is going to take years to do—that when we present a budget to the Congress, we will have more than we now do in measures of the consequences of the last increase to that program. For example, in the education field, we might say, "In the program increase we are requesting, each dollar tends to educate so many kids at such and such a level of quality and in such and such an area." To the extent each program can be laid out like that, then the Congress certainly will be in a better position than it is now to make judgments about the impact of its actions, up or down, on the basis of what we give you.

We do some of this now, but a lot more needs to be done.

Senator MILLER. I think that is fine, but I repeat I don't believe it goes far enough because it seems to me you ought to say these are our relative priorities and if you are going to increase here, you should cut someplace else and here is the schedule of where we think the cuts should come. It is for you to decide it: "Our recommendations, however, are that Congress leave the budget alone. But if you see fit to increase it, then here are our recommendations for where it should cut on the other side." Without that guidance, I think we are having an awfully difficult time.

Now in your reference to the dynamic revenue-GNP relationship, I must confess that I am very restive over what I consider to be an undue emphasis given by this administration to GNP as such. I would like to ask you, when you refer to GNP in there, are you referring to the GNP figures such as we find in Economic Indicators—I hope you have a copy there—the table on page 2, in the second column where it says, "Total gross national product."

Mr. SCHULTZE. The $658 billion for the last quarter; yes.

Senator MILLER. Yes. May I suggest to you that I think you ought to refine it much more. We have had hearings here to which a number of noted economists have come and I believe many of them have pointed out that that figure is not particularly useful, not very sound.

First of all, it seems to me what we ought to do is to cut it down to size, namely, to real GNP.

Mr. SCHULTZE. In the first column?

Senator MILLER. The first column. The second column, which includes inflation, to me is rather meaningless. What we are after is real dollar GNP.

(The table discussed here is reprinted from Economic Indicators, July 1965:)

Period	Total gross national product in 1964 prices	Total gross national product	Personal consumption expenditures	Gross private domestic investment	Net exports of goods and services	Government purchases of goods and services					Implicit price deflator for total GNP, 1964=100 [3]
						Total [1]	Federal			State and local	
							Total	National defense [2]	Other		
	Billions of dollars, quarterly data at seasonally adjusted annual rates										
1953	448.9	365.4	232.6	50.3	−0.4	82.8	58.0	49.3	9.0	24.9	81.4
1954	439.8	363.1	238.0	48.9	1.0	75.3	47.5	41.2	6.7	27.7	82.6
1955	473.4	397.5	256.9	63.8	1.1	75.6	45.3	39.1	6.6	30.3	84.0
1956	483.5	419.2	269.9	67.4	2.9	79.0	45.7	40.4	5.7	33.2	86.7
1957	493.0	442.8	285.2	66.1	4.9	86.5	49.7	44.4	5.7	36.8	89.8
1958	486.0	444.5	293.2	56.6	1.2	93.5	52.6	44.8	8.3	40.8	91.5
1959	518.1	482.7	313.5	72.7	−.8	97.2	53.6	46.2	7.9	43.6	93.2
1960	531.2	502.6	328.2	71.8	3.0	99.6	53.1	45.7	8.0	46.5	94.6
1961	541.6	518.7	337.3	68.8	4.6	108.0	57.4	49.0	8.9	50.6	95.8
1962	575.7	556.2	356.8	79.1	4.0	116.3	62.9	53.6	10.2	53.5	96.6
1963	595.3	583.9	375.0	82.0	4.4	122.6	64.7	55.2	10.3	57.9	98.1
1964	622.6	622.6	399.3	87.7	7.0	128.6	65.5	55.4	11.2	63.0	100.0
1964: I	612.9	608.8	390.0	85.9	7.7	125.2	64.3	54.0	11.5	60.9	99.3
II	620.2	618.6	396.1	87.2	5.7	129.6	67.1	57.0	11.0	62.5	99.7
III	626.6	628.4	404.6	87.3	7.0	129.5	65.5	55.2	11.2	64.1	100.3
IV	630.6	634.6	406.5	90.4	7.7	130.0	65.3	55.3	11.3	64.6	100.6
1965: I	641.5	648.8	418.1	94.7	5.0	131.0	65.1	54.4	11.9	65.9	101.1
II [4]	647.5	658.0	423.0	94.3	7.1	133.6	66.7	55.4	12.4	66.9	101.6

[1] Less Government sales.
[2] Prior to 1959, this category corresponds closely with budget expenditures for national defense, shown on p. 35. Beginning with 1959, they differ because of inclusion of space program expenditures in this table; these expenditures, small in 1959–61, amounted to $4,300,000,000 in 1964.
[3] Gross national product in current prices divided by gross national product in 1964 prices.
[4] Preliminary estimates.

NOTE.—Data for Alaska and Hawaii included beginning 1960.

Source: Department of Commerce.

Mr. SCHULTZE. As an objective, I agree with you.

Senator MILLER. All right. The second thing is that I think we ought to look at the per capita GNP increase. That would seem to me to be much more meaningful than just a blanket real GNP increase.

It may be that we have a real GNP increase but we have gone down on a per capita basis.

Mr. SCHULTZE. It has happened. There have been periods in the past when this has happened. May I point out that I couldn't agree more except that each number has its own objective. If we want to look at the best single number to tell us what is going to happen to revenues, it is the total GNP in current dollars. If we are asking what has happened to the real output of the economy, it is real GNP. If we want to know one single measure of welfare per capita, maybe GNP real per capita is the best one. Each number has its own use, however, and my use of the relationship between taxes and GNP does not imply that current dollar GNP is the best measure of how well we are doing, but it is the best single indicator of what is likely to happen to revenues.

This is why I use the term here.

Senator MILLER. And then finally, on the same subject, it seems to me that we ought to do much more in a qualitative evaluation of the GNP because if all of the GNP increase has emanated from the Government levels, this might look good on paper but it might mean that we are having a real recession in the private economy. Do you not agree? In other words, if the increase comes from increased governmental expenditures at State, Federal, and local levels, and the increase does not come from the increased expenditures in the private sector, then aren't we missing the boat? So it seems to me we ought to have a qualitative evaluation of the GNP also if we are really going to have something that is meaningful when we refer to dynamic revenue GNP relationship.

Mr. SCHULTZE. Well, of course, it is a little hard to respond to that question. A lot of the measures that would be necessary to make the kind of evaluation that you have suggested are available. We do use them. We do talk in those terms.

Senator MILLER. But I never see them.

Mr. SCHULTZE. Here they are, for example, right in the table you looked at, parts of it. Don't get me wrong. I am not saying we couldn't do more, but the GNP is broken down. We can break it out as to the private and the government sector. Within the government sector you can break out Federal and State and local.

Within the private sector, you can break out investment versus consumption. There are a lot of other things you want to look at. What is the quality of consumer goods, for example.

Senator MILLER. Also how good this ratio is that is broken down here in your judgment.

Mr. SCHULTZE. Yes, and this, of course, is going to vary from time to time. There is no one, sacrosanct relationship. It will vary in the context of economic analysis. A lot of this—and you may agree or disagree with the analysis—is precisely what the Council of Economic Advisers does each year in its reports: it attempts to analyze the developments in the economy in terms of private versus Government, Federal versus State and local, investment versus consumption, and to make some judgments.

You may disagree with the particular conclusions they come to, but this is the kind of thing they do.

Senator MILLER. Thank you, my time is up.

Representative GRIFFITHS. How do you evaluate social security programs in relation to each other and in relation to other programs?

Mr. SCHULTZE. That is a good question. I can't just flatly say I can give you an answer, but I can list the kinds of things you want to look at.

First, I think you would want to ask yourself what proportion of our resources are we putting into the social security area, into assisting the aged versus the proportion we are putting into assisting individuals in other circumstances—teenage school dropouts, preschool programs, and so forth. So I think that is one way you would want to look at it; that is, to rack up the resources that the Federal Government and the economy as a whole are putting into these areas.

Secondly, I think you would want to ask yourself what kind of resources are we putting into straight income maintenance—where we are passing out specific checks—compared to resources that we are putting into, say, building up the productivity and education of the population?

In other words, where we have these kinds of human resource programs as opposed to brick and mortar programs, how are we distributing our effort between maintenance of income and productivity increase?

Then, I think you would have to ask yourself what are the financial implications of these social security programs in terms of the size of the payroll tax, the implications of this tax in comparison to other levels of taxes? These are the three, it seems to me, major questions you would want to ask.

Now, then, within each of these, there are a host of individual questions that quite frankly I am not prepared—without an awful lot of additional thought—to answer.

For example, one of the things we have faced up to in Congress—I gather the conference committee has, at least, and I presume the Congress has already decided—is the specific health aspects of the social security program including how much do we want to put into cash per se and how much into a specific health program. The Congress made that decision or just about made it.

Representative GRIFFITHS. Well, now, next week they are going to make it. And it seems to me that when the decision is made and medicare goes into effect, that there is going to be created a new problem, a problem really that already exists but it is going to be accentuated.

There is a tremendous shortage of doctors in this country. There is tremendous shortage of nurses. Are you considering educating doctors, educating nurses at Federal expense?

Mr. SCHULTZE. My recollection—I want to check this for a moment with my colleagues—my recollection is we already have a program in which the Department of Health, Education, and Welfare is contributing to the education of doctors through medical schools, dental schools, and nursing schools. I must confess I am not precisely sure of the magnitude involved, but, we already are in such a program.

Representative GRIFFITHS. Are you going to increase it? Are you going to contribute to the payment of the nurses' salaries? Because unless we have these things, then it is possible that there will come a moment when we have to increase this tax that is levied to support the program.

Is that not true?

Mr. SCHULTZE. Well, obviously, it is too early for me to answer precisely what we are going to do in next year's budget, but clearly one of the items that we will be looking at—and we would be derelict if we didn't in deciding the allocation of Federal resources next year—will be precisely this problem. I can't at this stage, of course, give you any answer as to what we are going to do, but, as I said, we have been meeting this summer with department heads looking at their program plans and the issues they raise; this is clearly one of the issues that is going to have to be discussed.

Representative GRIFFITHS. Well, I would assume that here is a program that could have an actual money value placed upon it. You could tell exactly what is going to happen as to the benefit.

Can you describe in a general way the instructions on cost reduction which you sent to the agencies

Mr. SCHULTZE. Yes. Essentially—well, let me try to give a little philosophy on this.

No agency head can carry out a cost reduction program by himself. It has to permeate all the way down through the department. If you look at what has been done in the Department of Defense, perhaps one of the greatest contributions has primarily been Secretary McNamara's tremendous capability at this sort of thing. It has been the fact that he has been able all the way down through the services—down to the grades 5, 7, and 9—to instill in them the importance of this sort of thing, the importance of looking at alternative ways of doing things. If you look at the specific kinds of things that have gone into this cost reduction, you will find that many of them have been suggested and worked out, not at the top levels of the Department of Defense, but all the way down the line.

So this is one thing that goes behind these instructions.

What we have done, therefore, is send out a specific memorandum—we call it a circular—to each department and agency requiring that they establish goals for cost reduction each year. In other words, we asked them not merely to do a good job but to tell us in advance what their goals are.

Secondly, that they indicate to us precisely what steps they are taking to set up the mechanism for getting this process down into the department.

Thirdly, that they provide an independent validation of their savings; in other words, don't merely come to us with, if you will pardon the expression, "guff," but show us how you set up an independent unit to validate the savings that you have claimed. The idea is to levy on them the requirement not to come up at the end of the year and say, "Here is what we did," but instead to come to us at the beginning of the year and say "Here is our target." This will give us and the President the chance to say, "This is too low, to match it up against the target and to take a look at their validation to make sure it is not just one paper but real. This is the essence of getting the program going.

Representative GRIFFITHS. This is a new procedure.

Mr. SCHULTZE. It is, that is correct.

Representative GRIFFITHS. Would you say that Government agencies are deficient relative to business in effective cost control?

Mr. SCHULTZE. I think that varies all over the lot, Mrs. Griffiths. For example, you can look at some agencies, or some parts of some agencies—let's say the Veterans' Administration issuing life insurance. Somewhere in this big book I have the numbers but rather than look them up I will try to remember them. In 1947 and in 1965, there were about the same number of life insurance policies handled. In 1965 the number of people involved in handling these policies was about one-fifth or less of the number of the people required in 1947. In other words, here is an index of unit manpower requirements going from 100 down to 20, approximately. That is a record that could be matched, I think, in very few places.

The same thing is true with respect to the Division of Disbursement at Treasury which passes out millions of checks. Again, I have the numbers buried here somewhere. I will be glad to furnish them. The increase in the numbers of checks processed per individual is absolutely astounding.

Now, in both of these cases it has been largely automation that has done this but also a very imaginative use of automation. There are other agencies. The Department of Agriculture has beat us to the gun, in a sense. They instituted a formal cost reduction program before we issued our circular, and they already have a number of small things and large things that they have done trying to get cost reductions.

Representative GRIFFITHS. Of course, one of the essential sanctions in business is that you can go broke.

Mr. SCHULTZE. That is correct.

Representative GRIFFITHS. The aim is a very effective sanction.

Mr. SCHULTZE. Except we have one sanction that private enterprise doesn't have, and that sanction is called Lyndon Baines Johnson.

Representative GRIFFITHS. I am sure you are right.

Now, I would like to ask you about some legends in Congress. I believe in the 80th Congress a Congressman came here who inquired about a certain purchasing agency in the Government and on investigation they found that this existing agency had been set up in World War I to purchase a particular type of wood for airplane wings—they had two wings on either side—and no one had every inquired before into this.

Later than that, a woman came to Congress who inquired about the way they were taking care of the mentally insane in Alaska. They had been taking care of them in Portland, Oregon. Alaska was perfectly willing to take care of their own insane.

How can you find out those things that are absolutely nonessential, that have continued generations through Democrats and Republicans and that are really just a waste of money.

Mr. SCHULTZE. Well, first, I can't say that we have found everything. But if you, for example, would take a look at the Director's review books which are what I get each fall to go through the budget. For a given agency, a sizable agency, it may be several inches thick, and this has been processed substantially down through the examination that our individual budget examiners have given it. In many cases, they know the agency as well as or better than anybody in the agency. They have been at this for a long time.

They are good people. That doesn't mean they don't miss things. Obviously they do miss some. But the depth of examination that we give in many cases—probably too much, as a matter of fact—but in any event the depth of examination we give to this means it is fairly hard for this kind of thing to slip by. That doesn't mean we do a good job necessarily.

Representative GRIFFITHS. Is this a new procedure?

Mr. SCHULTZE. No.

Representative GRIFFITHS. How long has it been done?

Mr. SCHULTZE. Well, the basic procedure has been in effect for many years. The specific depth of analysis will change from time to

51-884 O—65——6

time. The specific things we concentrate on will change from time to time.

As I say, I don't by any means want to leave you with the impression that we do the best of all jobs. Obviously we don't. It could be better. We try to do it better.

The second point on this is that we conduct and we are conducting periodically, joint management surveys of each agency. It is a joint process by the Bureau of the Budget, the Civil Service Commission, and the agency itself.

Now, its primary objective is not to look for freaks like this. There are freaks, but this isn't our real problem. They delve in tremendous depth into either the entire management of an agency or a specific part of it, and come up with recommendations which go to the agency head, to me, and to the Civil Service Commission, calling to our attention all kinds of things that need correction; more importantly, suggesting more efficient ways of carrying out the agency's activities. These kinds of reviews tend to flush up things that are going on that shouldn't be going on.

Representative GRIFFITHS. Well, I think one of the biggest problems of a bureaucracy is that you don't have a cost sheet. You can't go broke. So therefore it is hard to establish procedures that show you exactly what every item costs.

And the second one is you don't have a memory.

Mr. SCHULTZE. Some of them have awfully long memories.

Representative GRIFFITHS. People come and go and things that were established remain whether there is any longer a need for them or not. And so I hope that you are in some way attempting to stop this. I notice that you pointed out that you are attempting to end programs which misuse our natural resources, "by using Federal resources inefficiently or to keep obsolete and low-priority programs intact," how do you find out which is a low priority?

How do you cut them out? How successful are you in cutting them out?

Mr. SCHUTZE. Well, let me give you an example of finding them. For example, this year we have already requested that every agency list its program increases—its proposed program increases—in two bands. One band consists of items that the agency head feels so important that he will identify for us explicitly where he would cut in order to get these in. And the second band, includes program increases that he still thinks are important but not important enough to go into this first category. The agencies have been explicitly told directly and personally by the President that in judging their program increases this year, he is not going to look at a penny of program increases until he has seen how they have matched them up with low priority increments that they are willing to take out.

So, in other words, what we have tried to do is force the identification of low-priority programs in the context of the new programs and program increases that each department head quite properly is asking for.

Representative GRIFFITHS. Senator? Would you like to ask some questions? I understand you have a rollcall.

Senator PROXMIRE. The leadership is going to delay it a little bit.

I am delighted to see, Mr. Schultze, that you have this great emphasis in your statement on evaluating the programs from the standpoint of efficient allocation of resources. I think that is a very happy and new accent in the economy drives. I am surprised that you didn't discuss in this connection what I thought was a revolutionary book that the Budget Bureau published a year or so ago measuring productivity because I thought your Bureau indicated an exciting new method which gave Government something it hadn't had before, put it on a comparable basis with private industry, and permitted you to measure from the standpoint of time how you were reducing costs and how you were getting more for each dollar of input.

Mr. SCHULTZE. We are continuing that and expanding it to a larger number of agencies.

Senator PROXMIRE. Glad to hear it. There were only five agencies you were reporting on at that time. In fact, for one of them—Interior—you didn't have a complete report.

Mr. SCHULTZE. We are still working on it. It is so complicated.

Senator PROXMIRE. Can this give you an evaluation pretty broadly throughout Government?

Mr. SCHULTZE. There are a number of places it can be used. We are moving it into other agencies. It can be an exceedingly useful management tool in terms of identifying why productivity went up the way it did and why it didn't go up more.

Clearly, you can't use it mechanically. There are some areas where it is easier to get productivity increases than others. There are some you can't measure.

Senator PROXMIRE. This gives a marvelous impetus to things like computers and other automatic devices that enable you to get increases in efficiency. In one department you had 20 percent increase in efficiency, close to it, in 1 year.

Mr. SCHULTZE. As I mentioned earlier, there are two of them that have had an extraordinary record. This is the life insurance handling on the part of VA and the Treasury Disbursing Office. Both of these have had huge increases in productivity over the years. This is really another part of this business of measuring effectiveness against costs. Here, it is an attempt to measure the output.

The real beauty of the productivity exercise, as far as I am concerned, is not solely and perhaps even primarily the measurement of the productivity per se, but for the first time it forces us to measure output.

Senator PROXMIRE. Then you can establish and measure improvement.

Mr. SCHULTZE. Yes, sir. And rack up output against costs and inputs. We are pushing this.

Senator PROXMIRE. For Congress to contribute in this area, one of the notions that has occurred to me, and I suggested it to the Committee on Reorganization, was the idea of having an independent efficiency firm, McKinsey & Co., Booz Allen, and so forth, come in and study in depth each department, perhaps once every 10 years or 5 years. The purpose is, to get some outside group that wouldn't have a vested interest in defending a particular viewpoint. What do you think of the usefulness of this proposal?

If we had this kind of competent, professional, dispassionate analysis based on experience to study some of these departments, it might be a contribution we can make. I know you are doing it but I wonder if Congress might do it.

Mr. SCHULTZE. I want to meditate on that. It might be. I would want to meditate on it.

Senator PROXMIRE. Let me get back to the main thrust on this. You had a lot of emphasis, and very good, as we have said, on the efficiency evaluation but not as much as maybe we might desire on some of the fiscal aspects. We now have a unique situation in our Government. Not the Director of the Bureau of the Budget, not the Secretary of the Treasury, there is nobody who seems to have any real concern about the national debt, the size of the debt, and what is happening to the debt.

Can you tell me any time in which we have enjoyed substantial prosperity over a period of time in relative peace in which we haven't been able to reduce the national debt before?

It seems to me throughout the 1920's we reduced it, we did it in the periods after the Civil War, when we had prosperity.

Mr. SCHULTZE. I think it would depend on the condition of the economy.

Senator PROXMIRE. A new concept. I think it has a whale of a lot of merit but I am wondering if we are not completely ignoring the consequences of building up an enormous debt that now constitutes the second biggest cost of the Government, a big cost, a growing cost, what is it, $11 billion a year. And there doesn't seem to be any end to it. We have a deficit this year with the greatest prosperity we have ever had, a deficit next year, a deficit last year.

Mr. SCHULTZE. What we are aiming for is to get in the position—I must admit that by this time the phrase is a little shopworn—of a balanced budget and balanced economy.

Given the appropriate strength on the part of the private economy, then you can generate the kinds of revenue which makes it possible to balance the budget, and in many cases it is quite appropriate to reduce the debt. There have been periods in the past where we have had prosperity and reduced the debt. There have been other periods where trying to reduce the debt has been tried in order to maintain prosperity but instead has hindered it. It varies for different economic situations.

Senator PROXMIRE. Let me ask this. We had an $11 billion tax cut in the period of expansion and growth, a period of prosperity. How big a tax cut do you envision we might have if we were faced with a real recession? $25 billion? $35 billion?

Mr. SCHULTZE. No, sir. No, sir.

Senator PROXMIRE. Why not?

Mr. SCHULTZE. Well, I don't really think with all respect that is quite the way to put it.

Senator PROXMIRE. I mean, if we follow this position logically why doesn't it lead to that?

Mr. SCHULTZE. No. Because the whole point of this tax cut, that is inaugurating it, was not so much the fact that it was put in during a period of expansion. The key point is that it was put in during a period in which our economy was performing substantially below where it ought to be performing. Even though it was rising substantially, the rise was below the full capacity of the economy.

Now, in order to know what kind of a tax cut would be necessary to cope with a recession, it isn't so much comparing the recession with the fact that we had an $11 billion tax cut in a period of prosperity but rather of comparing the economic situation of the time to the distance we were from where we ought to be; in other words, how big was the unemployment rate, how big was excess capacity?

Senator PROXMIRE. Yes, but why not compare it on that basis?

After all, the economy could have performed better but it was performing quite well. It was expanding, growing, unemployment dropping somewhat. We had about 85 or 90 percent utilization of capacity.

We had about 94 or 95 percent of our work force employed. Now, if we had a situation in which we have 75 percent utilization, only 85 percent of our work force employed, wouldn't there be on this basis a strong argument for a huge tax cut?

Mr. SCHULTZE. Well, I think if we were derelict enough to let the economy get into that situation, it might require Draconian measures. My point would be that there is no reason why we should ever let the economy get to the point where we would need that size of a tax cut.

Senator PROXMIRE. You really feel as a man with great economic background and great ability that we can prevent a recession forever?

Mr. SCHULTZE. No sir.

Senator PROXMIRE. That is what I am talking about. I am not talking about a 1932 depression. I am talking about a recession of the kind we have had since World War II.

Mr. SCHULTZE. Seventy-five percent of the labor force employed would be 1932. If you look at the kind of recessions we have had since World War II, we have been dealing with unemployment rates dropping off from 4 to 7 percent. We are not talking about dropping off from 4 to 15 or 20 percent.

Senator PROXMIRE. Well, my figure was 85 percent. But it may have been extreme.

Mr. SCHULTZE. All I am getting at was that I don't want to say that we can prevent every little wiggle in the business cycle. What I do mean is that we can prevent a lot of them, if not most of them and at the same time we can—I am not saying we will—but we can prevent any really major slides and by major slides let's say something between the size of the postwar recession and 1932.

Senator PROXMIRE. Well, these minor slides—we had a dip in 1954 and one in 1958. We haven't had anything like that really since the Kennedy-Johnson team took over.

Mr. SCHULTZE. One in 1960 just as they came in.

Senator PROXMIRE. And yet we have had this huge tax cut. The gross national product has been going up steadily since 1961; if it drops and unemployment increases quite sharply, isn't this an argument for a really mammoth tax cut.

Mr. SCHULTZE. I don't think so, sir. If it just drops slightly there may be an argument—probably would be an argument—for a tax cut, but that doesn't mean it would have to be. Let me do it another way. The recession of 1960–61 was the smallest post-war recession we have had, but it led to just about the largest unemployment because it started from a low position. One of the reasons for the need of a tax cut as large as we had was not because the recession itself—which we were then beginning to recover from—was so large but because it started from a peak which was a submerged peak. And I would again insist that the way to judge the size of the tax cut that would be needed—there are a lot of things you would have to do but one of the major things—would be to judge it in terms of where you are, where the economy is relative to where it ought to be, not how big the downturn itself is.

As I say, 1960–61 is a good example of that: a very small downturn but from a submerged position.

The other interesting point of this is that from 1955 to 1961 we had no tax cuts. Budget revenues went up by $17.4 billion. From 1961 to 1966 fiscal year, which we are now entering, we have had tax cuts which effect the 1966 budget by something like $15 to $16 billion and yet over that 5-year period, tax revenues are going to rise more than they did in the prior 6 years.

If we look at the pattern of price increases between 1955 and 1961—when we had no tax reduction—we find they were substantially larger than the increase in the Consumer Price Index since then. I would say that because we were judging it in terms of the excess capacity and unemployment in the economy we were able to put the tax cuts in to sustain the expansion—which could not have been sustained without the tax cut—yet end up without a price increase but with a larger increase in revenues than we got in the prior 6 years when we had no tax cuts.

Now, I can't sit here and honestly say that all of this is due to the tax cut, but I think I can sit here and honestly say that we would have had much poorer economic conditions and very little different price history if we hadn't had the tax cut.

Senator PROXMIRE. My time is up and there is a rollcall but let me just ask one final question. Do you feel that the social security bill which we just passed, the conference committee has just reported it out, and the other proposals of the Great Society which are being enacted into law, have so increased our automatic stabilizers that this, too, is a factor which would prevent us moving into a very deep recession, would automatically create a fiscal stimulus that would probably prevent the kind of depression that we have had in the past.

We still have to be alert to be able to reduce taxes and to increase spending.

Mr. SCHULTZE. I don't think we have increased the automatic stabilizers that much, if at all.

Two points. One, my recollection of the studies I have seen on this is that social security payments respond very insensitively to changes in economic conditions. They do respond but it isn't big. Unemployment insurance does but the social security does not respond very rapidly to a moderate recession.

Secondly, the fact that we have cut the level of taxes—which has been, of course, very good for stimulating the economy—means that the automatic tax changes are somewhat less than they used to be. I would say on balance we haven't changed the automatic stabilizers substantially. We still need to be alert with appropriate discretionary action.

Senator PROXMIRE. Thank you.

Representative GRIFFITHS. I would like to ask you, supposing all the agency heads bring in their requests. Now, they followed your advice. They cut out all the bad programs. They reduced expenses. You add up all requests and you ask Mr. Fowler the anticipated tax revenue and you discover that you are going to have $2 billion more in tax money that you have requests. What would you do?

Mr. SCHULTZE. Well, I think the first thing we would do—we would be doing it simultaneously with this—is look at the economic situation.

Representative GRIFFITHS. Yes. Supposing it is just as it is right now. What do you do?

Mr. SCHULTZE. Well, I think first of all, I would have to go back and maybe change your assumption a little—if you don't mind—that we would necessarily be satisfied with the agency's judgment on what are low-priority programs. By that I mean—with all good will in the world, and this is not a criticism—their job is one thing, my job is another. I am the skeptic. I am paid to be a skeptic. Their job is quite properly both to economize but also to recommend to the President program increases where it will accomplish their goals. We have honest differences of opinion. So it isn't only a question of then going back to Mr. Fowler and saying we had better get together on a tax change. It may very well be saying, well, there is an area of legitimate and honest disagreement in here with respect to what might be recommended to the President for his consideration.

The advice we give to the President on both sides of this question, in other words, can change because it is not a question, for example, of a low priority program which ought to be cut out versus a high-priority program which ought not. It is a matter of degree and there are legitimate differences here as to how far you go in financing new programs, as to how far you go or, to what level of priority you force these programs back. So I would say we would still have open some area of flexibility in deciding, really bringing forward to the President for his decision, the issue of the relative emphasis on taxes versus expenditures.

That is not a very good answer, I realize, but it isn't a nice, clean thing.

Representative GRIFFITHS. You wouldn't automatically say, fine, we will pay off $2 billion of the national debt?

Mr. SCHULTZE. Not necessarily. We might or might not, depending on the circumstances.

Representative GRIFFITHS. Under what circumstances would you pay on the national debt?

Mr. SCHULTZE. For example, if our economic analysis indicated that we were starting to press up against our available labor force and industrial capacity, that we needed to damp down the rate of increase in expenditures in the economy, either private or Federal, then we would, it seems to me, want to come to the decision that we wanted to generate that kind of a surplus.

For example, during most of the years after World War II, that was the position; that is what we should have been doing. We did to some extent. We had inflationary conditions.

Now, again the question is still open whether you do it through the tax route or the expenditure route. But this is the kind of thing, it seems to me, that would be of primary importance here; that is, do we need to let fiscal drag exert itself and how much And we ought to be just as willing to let fiscal drag exert itself where the circumstances allow as we have been willing, and the Congress has been willing, to reduce taxes when it was needed on the other side of the coin.

Representative GRIFFITHS. But the national objective, bluntly, is not necessarily to balance the budget and pay off the debt.

Mr. SCHULTZE. Well, I guess you would say, I would have to put that slightly differently, that the national objective is to get the economy into a position in which the balanced budget would be the proper thing to do, and we think we can do that.

Representative GRIFFITHS. Of course. How much of the increase in debt of the Government over the past two decades is now held by Government itself; social security and so on?

Mr. SCHULTZE. I can get you that. A substantial amount is held by two groups. By Government I presume you include the Federal Reserve, and the social security trust funds. It is a very substantial amount, but I don't have it here.

Representative GRIFFITHS. Would it be about a third?

Mr. SCHULTZE. I can give it to you right now.

Representative GRIFFITHS. About a third?

Mr. SCHULTZE. Of the increase? Between the Federal trust funds and other Federal agencies, which held $61 billion of the public debt as of June 30, 1964, and the Federal Reserve banks, which held $35 billion, about $95 billion was held between the two. What the increase has been, I am not sure.

Let's take from 1939 to date. Can we do it that way—1939 to date—I have December 1964 figures. The total increase in the debt was about $270 billion, round numbers. Of that amount, of the $270 billion increase, rounding, almost $55 billion was accounted for by the Federal Government investment accounts. So of $270 billion, $55 billion of the increase was taken up by Federal Government trust funds and the like and about $35 billion by the Federal Reserve banks, or about $90 billion out of the $270 billion, or let's say roughly one third.

Representative GRIFFITHS. Do you think that the cost-benefit analysis could be applied to questions of taxation?

Mr. SCHULTZE. Yes, and it is in a sense in terms of looking at the benefits, if you interpret that as I think it ought to be interpreted, as to how it serves national purposes and try to get that as quantitatively as possible. We attempt to do this. In other words, what does a given tax cut on corporations do to investment? We have got an awful lot to learn about that, but we attempt to do it.

Representative GRIFFITHS. All right. What was the result, then, of the depreciation guidelines tax cut? What was the result of that and the investment credit? What is your interpretation of the results?

Mr. SCHULTZE. Well, first, quite frankly, I don't know. In other words, I don't have any numbers to give you. That is No. 1.

Representative GRIFFITHS. Yes.

Mr. SCHULTZE. I suspect, if I had to analyze this, that if you look at the way the economy was going in 1962 when the economy itself was tending to level off, that without those two tax cuts, investment rather than continuing to expand moderately would have probably fallen off, but I can't give you numbers on this. This would be my own interpretation, but I can't give you numbers on it.

Representative GRIFFITHS. What, in your judgment, was the result of the 1964 tax cut?

Mr. SCHULTZE. Well, I would say, first, although I could never prove this, that I am morally certain that we could never have sustained the expansion into its 53d straight month without that cut. Unemployment has been reduced from something like 5¾ percent down to 4¾ percent.

Now, that doesn't sound like a lot but it is a large amount in terms of total increase in national output. Looking at the economy, the way it was behaving at the time that we put the tax cut in, and trying to look ahead at the expansionary factors, I am morally certain that we probably would have run into a recession by now.

I am morally certain too that we would never have had the kind of expansion we have had since then. So I would have to do a little figuring on a piece of paper as to the exact GNP amounts which would come out of each of these assumptions, but it is very substantial in terms of real growth in economic activity.

Representative GRIFFITHS. What do you think will be the results of the tax increase next year?

Mr. SCHULTZE. Are you talking about the social security tax?

Representative GRIFFITHS. Yes.

Mr. SCHULTZE. You have to remember that these tax increases are balanced by increases in benefits. So considering calendar year to calendar year, the net stream of cash flow into and out of the economy on account of the social security bill—and I have not been able to price this out on the basis of the conference—will roughly reduce the net flow by about a billion and a half dollars, which is relatively modest in this whole picture.

Now, the timing is a little tricky because you get part of the benefit increases right now, in other words, the second half of 1965. You then get the tax increase through 1966 and then get another round of benefit increases in midyear 1966 as the medicare part of it comes into effect. But if you follow through these humps, you will find—and I am fairly sure of this—that the net calendar year to calendar year depressing effect—if you want to look at it this way, the net settlement of the benefits and taxes—is relatively modest. It is something we have to take into account clearly in considering fiscal policy for next year, but it is not of a national magnitude. You can't look at the taxes alone and see what is going to happen because you are both putting into the economy and taking out of the economy.

Representative GRIFFITHS. What would you say about a tax cut that cut the paroll tax at the lowest level?

Mr. SCHULTZE. Every day I think about this, Mrs. Griffiths, and I come out with a different answer. I have thought about this, and really, what you are getting at—well, let me state your question another way: What do you thing about general revenue financing of trust funds? That is what is implied.

It is a very difficult problem and I haven't thought my way through it.

Representative GRIFFITHS. In my judgment, the real reason for earmarking a tax is to make sure that you get the benefits. That is, if you have to leave to Congress the question of whether or not they are going to apropriate so much out of general funds every year, you may not get the benefits. This was originally, I am sure, the theory.

I understand Mr. Mills' argument is that this earmarked tax is a conservative way to pay. Personally, I don't think that is necessarily true because I feel that you spend the money that is there. You sit up nights figuring how to spend it, and therefore it is not necessarily conservative, and as a woman I would like to say that most of the increases in benefits that have been made possible in social security have been made possible by women who worked. You are paying them out to everybody else in the country. So that if you suddenly withdrew those women as payers into that fund from which they never get a benefit——

Mr. SCHULTZE. Or at least a smaller benefit.

Representative GRIFFITHS. That is right. But you wouldn't have these people able to sit up nights to figure out ways to spend that money. So that I don't think it is the most conservative way to finance any program.

I think it might have been much more conservative to have financed it out of the general funds, but you wouldn't have gotten it because Congress just wouldn't have done it.

Mr. SCHULTZE. Well, your first hypothesis is a frightening one, I will say. Taking women out of the labor force. When I think what would happen to the quality of the Congress, I am appalled. But I think I would have to agree with you that this is not the most conservative way of financing social security.

Representative GRIFFITHS. No, it isn't.

Mr. SCHULTZE. I refuse to say whether that is good or bad but I agree with you.

Representative GRIFFITHS. No. It isn't the best way. Where is the program evaluation done in the Bureau of the Budget?

Mr. SCHULTZE. Well, it is done every day and most particularly—first, it is done every day because this is the real goal in life of our examiners. We have budget examiners. They are not green eyeshade types. They are not bookkeepers. These are program evaluators. In that sense, every day of their life they spend doing this.

The thrust I am trying to get at is to get more systemization, not even primarily at the Budget Bureau but at the individual departments and agencies. By systemization, I mean attempting to be a lot more specific in measuring—not always by numbers, but as specific as can be— and laying them out against costs. Then, when our examiners receive budget submissions and are evaluating programs, they can work on a much more realistic, hardheaded basis in terms of laying the two out. That is No. 1.

No. 2, we are setting up very explicitly what I refer to as our "little barn" whose precise objective in life would be—within the Bureau, but also within the departments and agencies—to attempt to get into each program justification that comes over to us measurement of objectives; in other words, how to measure performance. If you can't measure it, at least give us some quantitative statements about it. What would be the implication of changing the level of the funding in this program by, say, another, whatever it is, 5 percent or down? What would you lose? What would you gain?

So that when this ultimately comes up to the Department heads, to me, and ultimately to the President it can be put into the kind of form which makes intelligent decisions easier. This sort of think does not make decisions for you. If it did, we ought to throw it out. We don't want a group of anonymous experts making the kind of decision the President and Congress should make. What we do want to do is lay out the choices and alternatives.

Representative GRIFFITHS. Facts.

Mr. SCHULTZE. Make decisionmaking more rational.

Representative GRIFFITHS. How many people do you have working on this?

Mr. SCHULTZE. Well, first as I said, I consider that almost everybody in our shop is working on it.

Mr. ROSS. You have about 155 professionals in the divisions.

Mr. SCHULTZE. I would say 155 going at this, program by program, all the time. We have a larger number of professionals working on across-the-board matters but 155 working on this. In addition, we are beginning to staff up this very small systems analysis operation. We have a number of consultants in for the summer. Some of them will be staying on part time. The size of this operation will probably not get above 5 to 10 for quite some time.

Representative GRIFFITHS. In program analysis do you really try to see to it that the last dollar spent in one program gets the same benefit as the last dollar spent on another program?

Mr. SCHULTZE. That is what all my textbooks tell me I ought to see. No. We try, sure, but I can't say we can really nail it down.

Representative GRIFFITHS. How well can you measure the benefits.

Mr. SCHULTZE. It varies from program to program. For example, when the Secretary of State comes over, how do you measure what the effectiveness of the U.S. foreign policy is?

But when the FAA Administrator comes over—and he is very interested in this himself, by the way—we press him on specific measurements.

Representative GRIFFITHS. I want to thank you very much. You did a wonderful job. I am very pleased. I am sorry that the Senators cannot return, that we now have a quorum call, and perhaps I should try to make it too.

Thank you for being here.

(Short recess.)

Representative GRIFFITHS. The committee will be in order.

Senator Miller would like to ask some questions.

Senator MILLER. Mr. Schultze, in your statement you mentioned the fact that there are built-in increases in tax collections that provide us, automatically, with a revenue margin adequate—in most cases more than adequate—to deal with unforeseen new spending requirements, such as the Vietnam situation, without necessarily having to enact increases in tax rates.

The thing that bothers me about that statement is that the last time I had seen a reference to the built-in tax increase, it was in connection with President Johnson's comment on the excise tax reduction bill. As you recall, that turned out to be substantially greater than the administration recommended. However, in his statement to the Congress, he pointed to the built-in tax increase which had been greater than had been anticipated at the time of the budget, which he said would be able to cover the excise tax reduction without interfering with the budget estimates as far as the deficit was concerned.

Mr. SCHULTZE. Right.

Senator MILLER. Unless there has been some new change in the estimated tax collections, it seems to me that they have been pretty well wiped out for fiscal 1966, so that the Vietnam situation, I suggest to you, would not be covered by that.

Additionally, later in your statement, you mention the fact that expenditures were scheduled to rise from $97.7 billion to $99.7 billion, or an increase of $2 billion, but at the same time, we have an increase of $4.3 billion in the Great Society-type programs.

I would invite your attention to the fact that that $99.7 billion had, I think, gone out the window.

Mr. SCHULTZE. I agree.

Senator MILLER. By at least $1 billion already. We did this the other day in the Department of Agriculture appropriations bill, in which we added approximately $1 billion to cover adequately the Commodity Credit Corporation deficit.

Mr. SCHULTZE. Those actions don't affect expenditures of the Department; they are covering prior expenditures the way that particular appropriation works.

Senator MILLER. That is so, but the fact is that that lifts the budget for fiscal 1966 by a billion dollars, does it not?

Mr. SCHULTZE. No; it does not lift expenditures by a billion dollars. It lifts appropriations or new obligational authority by $1 billion. I am talking about actual expenditures, checks paid out. What that agricultural appropriation for CCC does is cover their losses under prior authorizations. So your provision of that extra $1 billion, as I understand it, will not increase Agriculture Department estimated expenditures, because you are really appropriating to cover their prior expenses. That is about the simplest way to look at it. They have a built-in borrowing authority and you restore that borrowing authority——

Senator MILLER. But that increases the Agriculture appropriations by $1 billion over the $99.7 billion?

Mr. SCHULTZE. The $99.7 billion is not an appropriation number, it is an expenditure number. The new obligational authority is substantially different from the $99.7 billion. I don't have the exact figure.

Senator MILLER. Then I would invite your attention—or rather, I would ask you this: When we are talking about the $2 billion increase in expenditures and the $4.3 billion increase in Great Society programs, did not most of the room for that difference come from the military budget?

Mr. SCHULTZE. A very large part did. Over the last 2 years, room has come from three places: (1) Mr. McNamara's cost reduction program, which has actually reduced military expenditures; (2) increased disposition of federally held assets, particularly mortgages; and (3) smaller economies scattered throughout the Government.

Senator MILLER. But the bulk of it came from the military?

Mr. SCHULTZE. The largest single part did, that is correct.

Senator MILLER. All right. Now, on June 25, Senator Stennis, the acting chairman of the Senate Armed Services Committee, who is also the chairman of the subcommittee of the Appropriations Committee dealing with the military budget said this:

> Based upon a careful and extensive study and analysis over a period of several months I am compelled to suggest to the Senate and to the decisionmakers in the Pentagon that it is now time to reexamine the entire fiscal year 1966 defense budget for the purpose of insuring that funds will be available to meet our defense requirements, including our stepped-up activities in Vietnam and our peacekeeping operations in the Dominican Republic.
>
> The fiscal year 1966 budget was developed during the summer and fall of 1964. The fiscal year 1965 budget under which we are now operating was prepared 18 months ago. These are peacetime budgets and neither is overly generous. In neither was there any specific planning or programing for the large demands on our funds and assets which have resulted from our heavy involvement in Vietnam. There is, therefore, a very serious question as to whether the fiscal year 1966 defense budget is now adequate for our defense needs.
>
> The drain of the Vietnam operations on our military resources is substantially greater than is generally recognized. Except for the $700 million supplemental appropriation of a few weeks ago they have been funded out of a peacetime budget. Thus the men, equipment, and material sent to Vietnam come out of the hides of the military services. The effect on the readiness of the forces not committed to Vietnam is substantial. The situation is already serious. Without corrective action it could become critical in the months to come even if our activities should continue at the same level.

Now he went on to point out:

> A peacetime budget is being used to support combat operations which were not factors in the original planning. Unless the budget is revised upward and additional procurement is instituted in the near future, critical problems could arise in combat-essential firepower, mobility, and communications equipment.

I don't know what will be recommended by Mr. McNamara and the President, but all indications are that because of the Vietnam situation, the Congress will be called upon for substantially increased expenditures, probably commencing almost at once, for the Vietnamese situation. If this is so, then we have a change in the ground rules on the basis of which the fiscal 1966 budget was prepared. If we had had the same picture at the time the fiscal 1966 budget was originally prepared as we do now, would it not be likely that the military budget would have been larger than it was at the time this fiscal 1966 budget was presented to the Congress?

Mr. SCHULTZE. Well, as you indicated yourself, this whole question of what the requirements of the Vietnam situation are on the defense budget is now going through intensive review by the Secretary, which he will present to the President very shortly. I am not at all prepared to speak on what is going to come out of that.

I think two things have to be borne in mind: One, that one of the accomplishments over the past 4 years has been to build a military force with the capability of moving into a situation like this, giving us time to make the appropriate evaluation. This is what the Secretary is now doing. It is not as if we were caught flatfooted with no capacity. We do have capacity. The point is we do have time, and the Secretary has taken the time to investigate the situation and is now making a report on this. What that report will show, I do not know.

I think it is, as far as I can see, highly unlikely—although as I said, I have not yet seen this report—it is highly unlikely that this would require major revisions in overall military strategy, although clearly it is going to have an impact on the military budget.

Senator MILLER. Let's just say for the sake of discussion that a recommendation is presented to Congress to increase the military appropriations by a billion dollars over the amount originally recommend for fiscal 1966. I think we could assume that the same recommendation would have shown up in the original fiscal 1966 budget if at the time you people were all working on this you had foreseen what nobody could foresee. That being so, would it not be proper to, if not suspend, then reduce some of the expenditures being proposed or already proposed in the fiscal 1966 budget for some of these Great Society programs? For example, the proposed increase in the expenditures for the Office of Economic Opportunity and its activities, which I understand are about double what they were last year.

Mr. SCHULTZE. The appropriations are roughly double; that is correct.

Senator MILLER. Would it not be, getting back to this original priority thing that you and I talked about earlier, would it not be in order for the administration to point out that due to unforeseen circumstances, we now have to increase our military appropriation by a billion dollars and due to the priority that must be given to it, that some of these other programs, this economic opportunity program to which I have referred being only one as an example, should therefore have to wait a little longer before they get their increases?

Mr. SCHULTZE. Well, not necessarily, Senator. As I say, it is awfully difficult to talk about this in the abstract. It will depend, obviously, on precisely what the Secretary recommends, what the President sends up, and what the Congress does. But, on the other hand, it may very well have been the decision that—taking all things into account and given the necessity and desirability, of a number of these programs—total budget expenditures should have been a billion dollars higher than we sent up. As I say, it is awfully hard to do in the abstract. You have to be faced with the specific numbers to do this.

Senator MILLER. That is why I used the figure of a billion dollars.

Mr. SCHULTZE. As I say, only as an illustration. I can't say at this stage precisely what has been done in terms of the total. I do know that the antipoverty program has a very high priority with this administration. I certainly would not be prepared to say that if we had known this 8 months ago, the billion and a half in appropriations which we requested for the Economic Opportunity Act would have been any different. We still are faced with about a 4¾-percent unemployment figure, and we still have some excess industrial capacity. I am not at all prepared to say how the priorities would have come out. But I think it is pretty clear that in the case of the Office of Economic Opportunity, this in itself does have a high priority.

Senator MILLER. I apppreciate that, but it seems to me the highest priority must be to get on with the fighting and winning of the war.

Mr. SCHULTZE. I agree, sir. There is no question of that.

Senator MILLER. If that is so, something has to give somewhere along the line. What Congress needs from you people is some priorities.

Mr. SCHULTZE. What I am saying, sir, is again, it is difficult to evaluate this without knowing the numbers. But using the kind of numbers you were talking about, the decision may very well have been, given the state of this economy, that the best way to handle this was to consider an increase in the total size of the 1966 budget. We are not at all, by any means, sure that you would automatically, if you had known this before, have simply taken a billion dollars out of other places.

Senator MILLER. Of course, hindsight is always better than foresight, but we are not quite in the position of hindsight yet. We are still in the position to reduce some of the authorizations for some of these programs which were originally recommended under entirely different guidelines. The guidelines have been changed now due to this war. How much they have been changed we will probably find out in the very near future.

But it seems to me once you have built a budget on the guidelines and then the rules have been changed due to developments that we did not have any particular control over, prudence would direct that since the guidelines have been changed, then the budget figure should be changed.

Mr. SCHULTZE. I would have to say that prudence would also dictate, Senator, that we take a look at the economic situation at the time, the capacity, the availability of manpower, the availability of industrial plant and equipment, and so on, and make a decision with respect to the impact of additional military spending on this. As I now look at the economy again, using the kind of numbers you talked about, it seems to me there would be no necessity for immediately reducing other expenditures to make up for this.

Senator MILLER. Well, it just seems to me that if the No. 1 priority is adequately equipping our people to carry on this very miserable situation that we have in Vietnam, something else ought to give. That does not mean that it ought to be canceled, but it certainly ought to be suspended. We cannot fight a war and do everything else at the same time. I think if we try to do it, we are going to lose both ways.

Mr. SCHULTZE. Here I think I would have to disagree in two senses; one, I think in terms of the term "fighting a war." This brings to mind the size of operations of World War II or the very huge buildup we had in Korea. This is not the kind of situation we are facing.

Senator MILLER. I hope not.

Mr. SCHULTZE. At this stage, all we can do is look at it like this. We obviously have to make evaluations as events come upon us, and we may have to set priorities in other areas. What I am suggesting is there is no economic reason why doing what the President has suggested be done in the budget and the economy will interfere in any way whatsoever with our military requirements. Again, I have to emphasize this in terms of the kind of numbers you were using.

Now, I am not prepared to discuss hypothetically what would happen if this Vietnam situation turned out to be substantially larger or smaller. I think we will have to look at it at the time. But I don't want to leave the impression that each dollar of additional military spending necessarily must be accompanied by a reduction elsewhere, because this economy is such that it is precisely in a situation to absorb this and still produce what we need for the military and to provide the manpower we need for the military.

Senator MILLER. I, for one, would not say that necessarily we should have a reduction dollar for dollar, although it might be a good idea. That would be something that would have to be very closely studied. I just point out, however, that when we talk about the economy, I think we have to take into account the inflationary impact of further budget deficits and an addition to the budget deficit.

The thing that alarms me about it is that according to economic indicators over the last 4½ years, on the basis of the figures set forth therein, about every time we go a billion dollars deeper into debt, we have a billion dollars of inflation. It has actually been a little worse than that. During the first 6 months of this year, we have $6.5 billion of inflation.

In other words, the real increase in GNP is $6.5 billion less than the apparent increase in GNP.

Now, I have had occasion to reduce this down to meaningful terms as far as my own State is concerned, where we have had $7 billion of inflation. This has been the equivalent in loss of purchasing power to the people in the State of Iowa of a 2.5 percent sales tax. At the rate we are going, with a $13 billion annual rate of inflation, that is the equivalent of better than a 4-percent sales tax on the people of Iowa. It is worse in other States. Illinois, for example, and New York, are worse than that. So I think we have to take that into account in terms of looking at the economy to which you refer.

That is why I say if we try to do everything, try to fight a war and try to do everything at the same time, I just think we are going to end up possibly losing both ways.

Mr. SCHULTZE. Let me make two points with respect to that, Senator. First, when we submitted the budget in January, our estimate for the budget deficit for fiscal 1966 was $5.3 billion. Our latest estimate, before taking account of Vietnam, is $4.2 billion. So there is a billion dollar leeway. I am not suggesting one should measure it this way. As I say, it is a much more complicated phenomenon; so while the ground rules have changed, you are right; some of the estimates have changed in the deficit figure.

In terms of inflation, I know that in the last 4 or 5 years our record with respect to prices has been substantially better than any other major industrial country in the world. What we have done is to have a major tax cut, decrease our unemployment rate substantially, and since 1961, end up with a substantially lower rate of increase in prices than we had in the prior 5 years. Admittedly, it has not been a zero rate, but the price indexes are not perfect. With the consumer price index creeping up at the rate of 1½ percent a year—with a rate of increase of that magnitude—I am not sure that it isn't really half of 1 percent or 1½ percent or 1¾, the actions that we have taken, the fact that we have run some of these deficits, that we have cut taxes, have not ended up giving us a bad price history. It has been much better than the postwar period and much better than any other major industrial country in the world. We could do better, but it is still a pretty good record.

Senator MILLER. What bothers me is when we start talking about percentages, we can be deceived a little bit. A 1½-percent increase may not sound like much. We may find some retail prices of goods that are relatively the same, but I think you know we are now in what some people are calling a service type of economy because so much of the consumer dollar is being spent on services and this is where the big increases come.

We just have passed a social security bill which granted our social security pensioners a 7-percent increase in their pensions. But even with that increase, their purchasing power is not going to be as good as it was in 1958. So in a period of 6 years, there is a 7-percent impact on social security pensioners. So I think this 1.5 percent, while it is not galloping, is deeply serious. It is aggravating our budgetary requirements because we have so many people that are affected by the 1.5 percent. We have such a large gross national product that 1.5 percent inflation reflected in it, in the overall total of gross national product, ends up with approximately 30 percent of our increased gross national product consisting of inflation.

Those are my figures. Dr. Lutz, from Princeton, as you may know, takes an even dimmer view. He uses 1958 as his base point and says we have had 40 percent of the increase in our gross national product consisting of inflation. It seems to me that this is serious.

Therefore, I think we have to look at the impact on the economy which this inflation will bring by aggravating your original budget deficit figures.

Mr. SCHULTZE. I agree. The main thrust of my point is that precisely. We have to look at the economy and take a look at such additional military requirements as come forward in terms of their impact on the economy. If you look, as I say, at industrial plant capacity and unemployment, it is not at all clear to me that this added requirement will have—again, in terms of the order of magnitude you are talking about—will have an inflationary impact; as I say, in addition, the budget deficit we now estimate is somewhat below what we estimated 6 or 7 months ago.

Senator MILLER. There is another aspect to this. That is not just the money angle but the requirements for personnel.

Mr. SCHULTZE. The people; I agree.

Senator MILLER. If you have requirements for personnel to expand this economic opportunity program and you have requirements for personnel in connection with an increased war effort, that is a manpower problem which has also to be looked at. This is why it seems to me that prudence would dictate some kind of a priority designation on the part of the administration, and it probably would end up coming out of your shop to enable us to roll with the punch which we are about to receive on this Vietnamese situation.

I just want to ask one more question. This is the reference to fiscal drag. It seems to me that we are getting ourselves into a rather difficult position when every time there is a suggestion that we try to balance the budget so that we do not have to borrow more money, money which seems to lay the foundation for an increase in our monetary supply beyond our true economic growth, that we are faced with the suggestion that this is going to be fiscal drag. It seems to me that this is an unfortunate reaction to the suggestion of a balanced budget.

Now, the balanced budget has been targeted as an objective by the administration. There must be some reason for it. Yet at the same time, when suggestions are made that we try to cut down certain ex-

51-884 O—65——7

penditures in order to achieve a balanced budget, we are faced with the fiscal drag argument.

How meaningful is this? You have said in your statement:

> This administration believes that the present state of the economy requires the effects of fiscal drag to be substantially moderated.

Well, I do not quite know what you mean when you say, "substantially moderated." I do not know how this ends up in terms of budget figures. Are we talking about not reducing expenditures by more than a billion dollars to meet the war in Vietnam? What guidelines do you use in implementing the policy of "not substantially moderating" fiscal drag? Or substantially moderating fiscal drag?

Mr. SCHULTZE. Let me think. The best way to say it is that the objective of this administration is—through its fiscal policy through the tax reductions that we have had, and through keeping the rate of expenditure increases relatively modest—as I think you have to admit we have——

Senator MILLER. May I say at that point, I would admit that in some cases. I would not admit it in others.

Mr. SCHULTZE. I think we can agree to disagree with respect to some specifics.

In any event, the budgetary strategy has been to stimulate the economy, to keep it moving on an expansionary base, to keep it moving in an expansionary way, to bring the economy to the point where literally, we can let the fiscal drag operate. By that I mean we get to a balanced economy and a balanced budget in a high-level economy. This is the objective and it has already worked.

I was reciting some figures, I think, while you were gone, to Senator Proxmire. From 1955 to 1961, tax revenues went up by $17 billion—$17.4 billion, I think it was. That is a 6-year period. No tax cuts during that period. From 1961 to 1966, as we now see 1966, total tax revenues will climb by $17.8 billion compared to 17.4, slightly more. During this period, we have had a major tax decrease. Those tax cuts have helped move the economy from a 5¾ or 6 percent unemployment level down to a 4¾ percent unemployment level. The objective is to continue this, to move the economy to the point precisely where the revenues will be generated in combination with an expenditure strength which will give us the balanced budget in a high level prosperous economy. We think we can do this. We are moving in this direction. I think what we have said is that in periods starting with 1963 or early 1964 when the economy was limping along below its full potential, that not only can we afford, but we ought to have significant fiscal action—in this case tax cuts—to get the economy moving, even though initially this creates a deficit. But as the economy moves up, the deficit will shrink and it has shrunk. We can move to the situation not only where we have a balanced budget but where the balanced budget is a good, sound, fiscal economics policy.

Fiscal drag, for example, can be a bad thing at certain times, but it can be a good thing at certain times. If and when we get into a situation where utilization of manpower is pressing on our labor force and plant capacity is strained, then fiscal drag is a good thing. We ought to let it operate, and we would let it operate.

Senator MILLER. I appreciate that answer. It is most responsive. I just wish you would give a little more attention to the inflationary side of the picture, because it is not a matter of threat of inflation, Mr. Schultze; inflation is here. During the years 1961 through 1964, the calendar years, we had inflation, according to the statistics and economic indicators, amounting to $31 billion. I think that that should appear in the picture in evaluating this expansion, because this brings hardship to a lot of people. As I pointed out, our social security pensioners have been enduring this hardship until finally we have given them an increase which, even now, will not get them back to their purchasing power of 1958.

You mentioned the tax cut and I would like to tie in with the question that our chairman asked earlier. In determining whether or not we should have a tax cut, must we not take into account whether or not our problem is a regional problem such as Appalachia, or a structural unemployment problem in certain industries, rather than just looking at the overall picture dollarwise?

Mr. SCHULTZE. I fully agree; you have to look at both; yes, sir.

Senator MILLER. And if it is a regional problem, then expenditure, say for an Appalachia-type program, would be indicated as against a tax cut approach, would it not?

Mr. SCHULTZE. If we were faced only with a regional or structural problem, you are quite right.

Senator MILLER. Or employment?

Mr. SCHUTZE. Or employment, I agree.

Senator MILLER. I want to thank the chairman for her graciousness in returning so I could ask these questions and I want to thank you for your most responsive and fine answers.

Mr. SCHULTZE. Thank you.

Representative GRIFFITHS. I would like to ask one question about inflation myself. It seems to me that a part of the problem into which this committee should inquire would be the pricing structure of American industry. For example, if the excise tax cut is not passed on, that in itself is inflationary, is it not, if they do not pass it back to the consumer?

Mr. SCHULTZE. Yes.

Representative GRIFFITHS. Because you know immediately that every union will be in for more wages when they see those profit margins go up.

Mr. SCHULTZE. Right. Put it another way. As a general proposition, if we can get into a situation where some prices at least fall as others are rising, we guarantee ourselves a problem because, for almost precisely the reason you have indicated, you are going to find your wage demands geared very heavily to what happens in this kind of situation. I could not agree more.

Representative GRIFFITHS. The excise tax cut should have resulted immediately in lowered prices.

Mr. SCHULTZE. My recollection is—I might want to correct this on the record—but I am almost sure the Council of Economic Advisers is undertaking a study of this.

Representative GRIFFITHS. I think so. But if the excise tax cut had been passed on to the consumer, it should have lowered the cost-of-living index.

Mr. SCHULTZE. It would have changed the cost-of-living index from what it otherwise would have been. I do not think you can quite say it would have pushed it down, first in terms of the magnitude of items involved and their weight in that index. I do not know what the weights are, but I suggest they are probably not enough—given the fact that service industries are rising—to reduce the index. They should have kept it down below what it otherwise would have been. This is precisely what the Council of Economic Advisers is looking into.

Representative GRIFFITHS. Thank you.

Mr. SCHULTZE. Thank you, Mrs. Griffiths.

Representative GRIFFITHS. The hearings are adjourned.

(Whereupon, at 12:35 p.m., the subcommittee adjourned.)

(Appendix follows:)

APPENDIX

The following summary of the committee's compendium on Fiscal Policy Issues of the Coming Decade was prepared by the minority staff and is included in the record of the hearings as a guide to users of the publication.

A Summary of the Fiscal Policy Issues of the Coming Decade [1]

Late in 1964, Representative Martha W. Griffiths, chairman of the Fiscal Policy Subcommittee of the Joint Economic Committee, invited a number of individual economists and organizations to submit their views on what they believed would be the major fiscal policy issues of the coming decade. In February 1965, the replies of 48 economists and 10 organizations were published by the Joint Economic Committee in a volume entitled "Fiscal Policy Issues of the Coming Decade." The following outlines the areas of major agreement among the 58 respondents on what the issues of fiscal policy for the next 10 years are likely to be.

The consensus is that during the next decade, Federal revenues are apt to rise faster than Federal expenditures, thus exerting a drag on the economy. The respondents were hesitant, however, on recommending the proper remedy for fiscal drag, with no clear-cut consensus emerging for either increased spending or further tax cuts. A few felt that a budget surplus should be allowed to accumulate and the public debt reduced, but the majority of the respondents apparently did not feel this to be appropriate.

The overall feeling was that the 1964 tax cut was good for the economy, but that it was still too early to determine how good or whether any harmful side effects, such as inflation, would result. Detailed study of the effects of the tax cut was considered necessary before unqualified approval of further cuts could be given. Several respondents, however, stressed that tax cuts had certain advantages over expenditure increases in stimulating economic growth. One economist noted that tax reductions release funds for private consumption and investment directly. Another cautioned that further Federal spending would inhibit change, flexibility and growth of the economy and lead to greater economic centralization but not greater efficiency. A third respondent felt that further tax cuts would be particularly desirable if structured specifically to increase incentives to work, save and invest.

Other respondents gave their support to increasing Federal expenditures as the best means of eliminating any possible fiscal drag on the economy. They generally felt that military and space spending

[1] Prepared by Douglas C. Frechtling, minority staff, Joint Economic Committee.

programs would not increase at previous rates and that spending for social and welfare type programs should be increased to take up some of the excess. One respondent believed that repeated tax cuts would be ineffectual as stimulants and that increased expenditures were the answer. Another economist suggested that the Federal spending multiplier is greater than the multiplier for tax reduction. Several respondents felt that tax cuts and expenditure increases were equally as stimulating to the economy and that they should be used together selectively in the proper proportions to facilitate economic growth.

Generally speaking, three areas were emphasized as requiring serious study and effective solutions. They were (*a*) Federal-State-local fiscal relationships; (*b*) discretionary tax authority; (*c*) tax reform.

The area most mentioned was the fiscal relationship among Federal, State, and local levels of government. There was wide agreement among the respondents that increased requirements of a rapidly growing population, compounded by the rapid growth of large urban areas, demands that State and local governments sharply increase their expenditures. However, the traditional revenue devices available to and utilized by the State-local government often are inadequate, inequitable and inflexible, with the result that the States and localities are often unable to meet their responsibilities, even by undertaking debt financing. Over half of the respondents believed that financial assistance by the Federal Government is mandatory if the States and localities are to meet their responsibilities and still remain financially solvent.

Most of the respondents who touched upon this issue suggested that the Federal Government either turn over a portion of the revenues collected by the Federal tax system directly to the States and localities or increase transfer payments and grants-in-aid. The major point of disagreement was over how many restrictions and how much adherence to specified standards the Federal Government should require. Proposals calling only for very general guidelines, or none at all, were made, as were proposals for strict Federal Government scrutiny and supervision of how the States and localities spent the Federal aid.

Another proposal to aid States and localities was to reallocate tax resources. This might involve redesigning the Federal tax structure to leave certain revenue sources to the States and localities. It could also be accomplished by inducing States and localities to make greater use of certain revenue sources by offering Federal tax credits, rather than a deduction, for taxes paid to the State and local governments.

Over a third of the respondents touched upon the use of flexible, discretionary authority to raise or lower tax rates quickly as economic conditions require. It was felt that such power might be delegated to the President, an independent committee, or retained by Congress with some modification of present procedures. Several respondents suggested that the President be given the power to adjust income tax rates under conditions prescribed by Congress, including the use of economic indexes to determine rate adjustments and the limits within which the rates could be changed. It was also suggested that Congress be empowered to veto a tax rate decision made by the President within a specified period of time.

Another suggestion was to delegate the discretionary tax rate adjustment power to a commitee of seven, composed of those leaders in the administration and Congress charged with the responsibility of overseeing the Nation's economy. A few realized that it might be difficult to convince Congress to give up the power to make changes in tax rates, and proposed that special legislative procedures be developed whereby tax rate adjustments could be made more quickly than they are now. Although the advocates of discretionary tax rate adjustment authority disagreed on who should exercise the authority and under what conditions, the consensus was that quick implementation of tax rate adjustments was necessary to help counter economic fluctuations.

The last area generally agreed upon as a source of critical fiscal policy issues during the next decade was tax reform. Well over half of the respondents mentioned specific changes in the Federal tax structure, including modification of the excise tax, personal and corporate income taxes and estate and gift taxes. Only the changes most frequently suggested will be dealt with here.

The major portion of the suggestions related to increased equity and simplification of the entire tax system, especially the personal income tax. Equity considerations called for reducing the income tax load on the lower and middle income brackets and broadening the tax base. Special consideration should be given to revising the treatment of capital gains taxation, depletion allowances, exemption of State and municipal security interest, personal exemptions, and the single person's tax liability relative to that of the married couple. A few respondents believed the income tax structure is too progressive and dampens incentives. Others doubted the effect of the income tax on incentives.

In the area of corporate income taxation, several respondents felt that the tax on profits should be integrated with the personal income tax so that distributed dividends would no longer be taxed twice. It was also proposed that the corporate tax be replaced by excise taxation or a broad value-added tax or that corporate tax rates be reduced while depreciation and depletion allowances were moved.

A few respondents said that the estate and gift tax structure should be modified and perhaps integrated. Although some wanted to eliminate excise taxes completely from the Federal tax structure, others thought that wisely constructed excise taxes would counteract the extreme progressivity of the personal income tax. A broad-based Federal excise tax was proposed to induce increased saving and to allow the individual greater control over his income. Others felt that the encouragement of more saving was unnecessary and perhaps even detrimental to the economy at this time. Several respondents recommended studies of payroll taxes, such as social security and unemployment levies, to discover whether they aggravated unemployment. One respondent suggested that payroll taxes be replaced by a value-added tax. One other specific area of taxation mentioned as needing further consideration was that of education, with some support for the proposal to give a Federal income tax credit to those financially supporting a college or university student.

By and large, those who touched upon the area of tax reform as being a major issue in the years to come wished to base modifications in the Federal tax structure on equity considerations. Although equity was not sufficiently defined, it can be assumed that the principle was to tax each according to his true ability to pay. Very broad-based progressive taxes or regressive taxes with low rates and liberal exemptions for the lower income brackets were considered by most to be the proper solution. One question raised, which is worthy of serious consideration as a general issue, is, "Does the image of a 'good' tax structure change as its rates are reduced?"

Two other points pertaining to fiscal policy were frequently raised, although they were not given the general support as important issues that the above-mentioned areas were. One was the use of full employment budget analysis as a tool of fiscal policy. It was generally felt that this analysis was useful for determining the appropriate direction in which fiscal policy should move, whether budget surplus, deficit, or balance. However, serious reservations were expressed by several of the respondents. These included questions about the validity of the full employment budget concept, including its effect in generating inflation, whether such analysis by itself could point the way to full employment, the need to refine existing statistical techniques to make such analysis accurate, and whether full employment budget analysis ignores the absolute magnitude of the Federal budget as an influence on the economy.

The other point frequently raised was that it is necessary to take monetary policy into account when considering the effects of a given change in fiscal policy and vice versa. The question was raised as to whether fiscal and monetary policies should be used to complement each other to produce a needed change in the economy or whether, for example, a tight monetary policy may be desirable at the same time an easy fiscal policy is being implemented. Further study was called for of the effects of the two tools of economic policy on each other.

References to Expenditure Increases Versus Further Tax Cuts

Bach: Is it more desirable to raise expenditures or lower taxes? (8)

Brown: How much should be devoted to spending and how much to tax cuts? (13)

Burns: Annual tax cuts. (24)

Colm: Combination of tax and spending adjustments to meet particular situations. (32) No superiority of tax change over expenditure change or vice versa, however, after several tax cuts, increased spending is superior. (36)

Ford: Which is more beneficial, tax reduction or increased spending? (53)

Friedman: Appropriate level of taxes and expenditures. (55)

Harris: Spending multiplier is greater than tax cut and there is need for more welfare programs. (64) Implement spending programs or tax cuts according to number of jobs each yield. (66)

McKean: Favor tax cuts because large Federal spending inhibits change, flexibility and growth; weight spending centralization against decentralization. (90)

Pechman: Determine proper mixture of tax cuts and expenditures. (99)

Silk: Study tax cuts versus expenditure boosts in relation to the economy. (123)

Tobin: How should increasing revenues be distributed between spending and tax cuts? (140)

Vestich: Increase Government expenditures. (142)

White: Doubt the effect of income tax on saving, investment, and work incentives; larger, more rapidly growing income from spending than from tax cuts. (152)

Yntema: Federal expenditures to facilitate economic growth. (157)

The American Life Convention: Tax cuts are better than spending increases because they stimulate private consumption and investment. (170)

The Conference on Economic Progress: Tax cuts are ineffectual way of reducing unemployment, ignore needed government expenditures. (173)

The National Association of Mutual Savings Banks: Incentive-building tax reductions plus selective spending increases. (178)

NOTE.—Names refer to respondents and numbers to pages in Fiscal Policy Issues of the Coming Decade.

References to Federal-State-Local Fiscal Relationships

Bach: Study possible Federal budget surpluses being turned over to State and local governments. (8)

Baumol: More substantial contributions by Federal Government because State-local revenue sources have little flexibility. (10)

Brown: Increase portion of Federal revenues allocated to State and local governments? (13)

Buchanan: Return a share of Federal income tax revenues to States in form of bloc grants. (21)

Butler: Federal revenues be returned to States and localities? tax credits? (22)

Chase: Give Federal money to States with no strings attached because of inadequate State-local revenue sources. (25)

Cohen: Forego tax cuts in order to provide grants or direct allocations of Federal revenue to States and localities. (30)

Domar: Grants to States with or without strings? (38)

Due: State and local financial needs grow more rapidly than Federal needs yet State-local resources are more limited. (41)

Eisner: Divert some of vastly growing Federal revenues to States and localities through specific grants and/or general remissions. (43)

Everett: Take account of State-local revenue problems in designing Federal tax structure. (47)

Fellner: Allocate Federal revenues to States and localities only if income redistribution is desired or program benefits more than the State alone. (51) Bad State-local revenue systems is not reason enough for Federal remissions. (52)

Goode: Federal aid to States and localities through tax credits, specific or general purpose grants because State-local revenue systems are regressive, unresponsive, and levied on limited sources. (56)

Jacoby: Limited jurisdiction, inequities, and inefficiency limit State-local revenues yet the demand for their services is rising. (71) Need commission to study intergovernmental finance. (72)

Levy: Study increased Federal transfer payments to States and localities. (88)

Musgrave: Study: techniques for reallocating tax resources, present distribution of expenditure responsibility, incongruency of geographic areas of responsibility and fiscal resources, Federal responsibility for unequal regional development. (97)

Pechman: Possibility of funneling excess Federal revenues to States and localities. (100)

Shoup: Make grants only if Federal position is strong; assistance needed because there are differences in the States' resources, easier for Federal Government to raise revenue, and some State-local programs are of interest to the Nation. (120)

Silk: Regular tax remissions or grants? How much Federal control? (125)

Smith: Considerably expand Federal grants, scaled according to need with some Federal control over use. (131)

Teper: Divert a share of Federal revenues to State-local governments with appropriate standards and conditions. (137)

White: Greater Federal involvement necessary in State-local government because of size, mobility, and concentration of population; more elastic sources of revenue needed by localities; greater use of Federal block grants. (153)

Wishart: Artificial jurisdictions and archaic tax structures demand Federal aid with appropriate standards and control. (155)

Yntema: Study relation of Federal, State, and local fiscal problems. (157)

American Farm Bureau Federation: Federal withdrawal from certain tax areas or tax sharing? (161). Payments in lieu of taxes for Federal property? (164)

AFL-CIO: Federal grants for specific programs with specific standards. (167). Tax credits to increase State-local tax base and encourage income taxes at lower levels of government. (168)

Chamber of Commerce of the United States: Less reliance on Federal grants and more on State-local revenue sources; increased State reliance on income tax and less on excise and property. (171)

Conference on Economic Progress: How can States and localities meet rising needs with regressive taxes? (173)

Life Insurance Association of America: Turn over a portion of Federal revenues to States. (176)

National Association of Mutual Savings Banks: Remission of a share of Federal revenues and expanded grants, unconditionally with only broad, general safeguards. (179)

National Association of Tax Administrators: Unencumbered distribution of Federal tax revenues allows States and localities to determine program priorities. (183)

References to Discretionary Tax Adjustment Authority

Bach: Have President adjust tax rates under conditions prescibed by Congress. (7)

Chase: Danger of misuse of discretionary tax powers given to President. (26)

Colm: Contingency tax cuts activated by joint congressional resolution initiated by the Joint Economic Committee. (37)

Dawson: Power to temporarily raise or lower income taxes should be given to a committee of seven. (39)

Eisner: Give discretionary fiscal authority to Administration. (44)

Fellner: Countercyclical tax rate adjustments. (51)

Friedman: Possibility of varying tax rates for countercyclical purposes. (55)

Goode: Standby legislation to vary tax rates or Presidental power guided by indexes of economic conditions. (58)

Keiser: Discretionary tax authority given to President with legislative controls as proposed in 1962; immediate, flexible, better than spending, avoids delay, avoids political snarls. (82)

Musgrave: Prompt action by a suitable body while maintaining congressional control. (98)

Pechman: Presidential standby power subject to congressional veto as proposed in 1962. (100)

Seligman: Tax adjustment power given to President within limits set by Congress. (117)

Shoup: Formula by which rate or exemption allowance changes would be automatically enacted. (118)

Silk: Quick congressional action on taxation changes for countercyclical purposes. (124)

Smith: President initiates change in income tax rates through special legislative procedure guaranteeing prompt congressional action. (129) Limited Presidential authority to initiate variations in investment tax credit. (130)

Terborgh: More flexibility in the application of fiscal policy. (139)

Tobin: Increase tax flexibility without delegation of congressional power. (140)

White: Formula relating tax rate to economic indexes or limited Presidential discretionary authority to adjust rates. (152)

AFL-CIO: Quick, temporary tax reductions. (168)

National Association of Mutual Savings Banks: Discretionary, shortrun changes in tax rates needed. (177)

References to Tax Reform

Bach: Issues of tax equity: capital gains, depletion allowances, exemption of State-municipal securities, impact of regressive exercises. (9)

Baumol: Thorough program of tax reform needed. (10)

Brown: Implement investmnet incentives: reduce capital gains rates, shorten holding period, end double taxation of dividends. (13); eliminate overly progressive structure: overall, broad based flat tax on income; broad based excise or value-added tax instead of corporate income tax. (14)

Boulding: Penalize income increases due purely to price or wage rises. (18)

Buchanan: Simplify income tax, reduce corporate tax rates. (21)

Butler: Study incidence of corporate tax, burden on small business, incentives to invest. (22); tax credits to encourage education. (23)

Chase: Integrate corporate and personal income taxes, stiffen tax on long-term capital gains. (25)

Cohen: Reduce personal and corporate income tax rates, simplify the tax structure, study: exercise tax, social security tax, broad based excise tax at retailers' or manufacturers' level, trade-offs with higher exemptions in personal income tax. (29)

Domar: Education tax credit, Federal estate taxes, oil depletion and similar allowances, more liberal loss offsets, accelerated depreciation instead of investment credit. (38)

Due: Revise excise tax structure, broader based income tax with lower rates, simplification, study interrelationship of personal and corporate income taxes. (41)

Eisner: Study accelerated depreciation and investment tax credit, broaden tax base, tax all income on equal footing: apply tax to unrealized capital gains, correct excessive depreciation allowances and percentage depreciation allowances. (44)

Everett: Further revisions of depreciation allowances. (48)

Fellner: Reduce corporate tax rate instead of further investment and depreciation allowances, uniform consumption tax rate on nonnecessities instead of selective excises, study differential impact of direct and indirect taxes. (50); increase exemptions to aid lower income groups. (51)

Friedman: Study corporate tax rate structure and its relation to individual income tax. (55)

Goode: Income tax: adequacy of personal exemptions, tax relation of single return to joint return, exclusions from taxable income, personal deductions, treatment of capital gains and losses; study and reduce excises; payroll taxes aggravate unemployment? (57); integrate estate and gift taxes. (58)

Greenewalt: Simplify personal income tax, reduce steepness of rate to lessen restraint on incentives, relation of estate tax rates to income tax rates, review taxation of foreign subsidiary earnings. (59)

Groves: Estate and gift taxes: integration, exempt transfers to spouse, study time lapse between transfers; postpone tax on earnings for retirement; broad based income tax to replace excise and social security taxes. (61)

Houthakker: Increase personal exemption to remove special privileges, shift from corporate to value-added tax. (70)

Klein: Review tax structure for justice, equity, and incentive. (73)

Keiser: Personal income tax: plug loopholes, reduce progression, widen base. (85)

Levy: Revise tax structure. (86)

Musgrave: Structural tax reform, does image of a "good" tax structure change as rates are reduced? (97); replace payroll taxes with value-added tax. (98)

Pechman: Reform estate and gift taxes; personal income tax: reform single and married tax treatment, personal deductions, capital gains and other exclusions. (101)

Shoup: Carryback unused personal exemptions (118); study: optional modes of computation, simplicity versus complexity, coordination of corporate and personal income taxation, capital gains. (119)

Silk: Study: income tax equity and simplicity, impact of corporate tax on investment (123); restructure tax system: stimulate consumption relative to investment, shift from direct to indirect taxation such as value-added tax. (124)

Smith: Reform should rest on equity: capital gains treatment, excessive depletion allowances, unjustifiable income tax deductions. (132)

Teper: Relief for middle- and low-income brackets: reduce indirect taxes on necessities, raise exemptions and lower rates on moderate and low incomes. (137)

Vestich: Tax relief for middle- and low-income brackets (141); eliminate favoritism of: capital gains treatment, State and local bond interest exemptions, tax splitting device, family partnership, excessive depletion allowances. (142)

Wallich: Modification not elimination of excise taxation, perhaps value-added tax. (145)

White: Doubtful that income tax affects incentives. (151); most important is broadening the base and improvement of personal income tax, integrate corporate tax with personal income tax with proper treatment of capital gains, excise taxes justified only on sumptuary or benefit ground. (152)

Wishart: Removal of regressive State-local taxes, end concessions to business and upper income brackets, relieve burden on near poverty level families. (156)

Yntema: Examine taxes to determine: incidence, impact on incentives, differential burdens; review: corporate tax, excise versus value-added tax, high personal income tax rates. (157)

American Farm Bureau Federation: End double taxation of corporate dividends, defer or carry back self-employed unused personal exemptions and depreciation allowances, reduce tax on capital gains and increase holding period, double estate tax exemption. (163)

AFL–CIO: Eliminate taxation of poor, reduce tax on moderate income receivers to increase equity and reduce oversaving tendency. (168)

National Federation of Independent Unions: Deduction for educational expenditures. (184)

New York Stock Exchange: Too heavy reliance on direct as opposed to indirect taxes, broad based Federal excise tax to: increase personal control of income, encourage saving, least hinder economic growth; decrease rate on capital gains and increases holding period, repeal security issuance and transfer taxes, end double taxation of corporate dividends. (192)

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