319

TAX CHANGES FOR SHORTRUN STABILIZATION

HEARINGS

BEFORE THE

SUBCOMMITTEE ON FISCAL POLICY

OF THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

EIGHTY-NINTH CONGRESS

SECOND SESSION

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WEDNESDAY, MARCH 16, 1966

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

The subcommittee met at 10 a.m., pursuant to call, in room 4200, new Senate Office Building, Hon. Martha W. Griffiths (chairman of the subcommittee) presiding.

Present: Representative Martha W. Griffiths; Senators William Proxmire and Jacob K. Javits.

Also present: James W. Knowles, executive director; Nelson D. McClung, George R. Iden, economists; Donald A. Webster, minority economist; and Hamilton D. Gewehr, administrative clerk.

Representative GRIFFITHS. We are opening hearings on shortrun stabilization tax changes. The first two sessions of these hearings are devoted to panel discussions. These, we expect, will raise the many and difficult issues in the prompt adjustment of the Federal budget to changing stabilization requirements and suggest alternative courses of action which we might pursue.

At this point in the record I will insert the press release announcing these hearings and listing the witnesses.

[Press release, Friday, Mar. 11, 1966]

REPRESENTATIVE MARTHA W. GRIFFITHS ANNOUNCES HEARINGS ON PROMPT TAX CHANGES FOR ECONOMIC STABILIZATION

Representative Martha W. Griffiths, Democrat, of Michigan, chairman of the Subcommittee on Fiscal Policy of the Joint Economic Committee, today announced that the subcommittee will hold hearings on the need for and design of temporary tax changes which could be enacted promptly in response to a recognized need for stimulating or restraining the economy. This will be an examination of whether we can and should add deliberately made shortrun tax changes to the built-in automatic flexibility that now exists in our fiscal structure.

The hearings will focus on three topics: (1) Contribution of rapid tax changes to stabilization. Do we need to be able to react more promptly to changing economic stabilization requirements? What economic effects are likely to be associated with rapid tax changes? (2) Criteria for such tax changes. What principles should govern the design of such tax change? Should the changes be neutral, and what is neutral change? If not, what specific nonneutralities with respect, for example, to relative impacts on various classes of taxpayers and type of income, and on consumption and investment, should be provided? Do criteria for the changes vary with circumstances? (3) Technical design. What types of changes in which taxes should make up the total tax action? Can suitable changes be composed from existing taxes or do we need new taxes for this purpose?

The subcommittee will welcome statements for the record from interested individuals and organizations. Statements should be sent to Mr. Hamilton

Gewehr, Joint Economic Committee, New Senate Office Building, Washington, D.C.

Hearings are scheduled as follows—all sessions are open to the public:

WEDNESDAY, MARCH 16, ROOM 4200, NEW SENATE OFFICE BUILDING, 10 A.M.

Harvey Brazer, Department of Economics, University of Michigan.

C. Lowell Harriss, Department of Economics, Columbia University.

E. Cary Brown, Department of Economics, Massachusetts Institute of Technology.

James Buchanan, Department of Economics, University of Virginia.

THURSDAY, MARCH 17, ROOM S-407, THE CAPITOL, (AE-1), 10 A.M.

Arnold Harberger, Department of Economics, University of Chicago.

Robert Aaron Gordon, Department of Economics, University of California, Berkeley.

Carl Shoup, Department of Economics, Columbia University.

Henry Wallich, Department of Economics, Yale University.

FRIDAY, MARCH 18, ROOM S-407, THE CAPITOL (AE-1)

10 A.M.

Alfred S. Neal, president, Committee for Economic Development.

H. Christian Sonne, chairman, Board of Trustees, National Planning Association.

2 P.M.

Carl H. Madden, chief economist, U.S. Chamber of Commerce.

TUESDAY, MARCH 22, ROOM S-407, THE CAPITOL (AE-1)

10 A.M.

John C. Davidson, vice president, Government Finance, National Association of Manufacturers.

2 P.M.

Nat Goldfinger, director, Research Department, American Federation of Labor and Congress of Industrial Organizations.

We are privileged to have the opportunity which these panel discussions will afford of receiving the views of outstanding authorities on problems of the need for and design of better fiscal tools for achieving the goals of economic policy.

Tax and expenditure policies of the last 5 years have brought the economy nearly to full employment without inflation. The effectiveness of these policies for counteracting forces depressing economic growth has been demonstrated in a singularly convincing manner.

Obviously, we know how to achieve full employment from a position miles away from it. The question which faces us now is whether we can move closer to full employment from a position only yards away without an unacceptable rate of increase in prices.

This is a problem which we can face much more cheerfully than that confronting us 5 years ago. However, manuevering the economy into full employment without inflation and keeping it there will require of us a higher order of skill in fiscal and monetary management. We need to make finer, more sensitive adjustments through the Federal budget of aggregate demand to capacity supply than were necessary in the past.

We must be able to anticipate more accurately those inevitable surges and subsidings of private and public demands to which the economy is subject, and we must also be prepared to offset these changes in demand by prompt adjustments in the Federal budget before they result in cumulative departures from stability.

The real test of fiscal policy will be success in the management of a continuously full employment economy, and it is to initiate discussion and awaken public understanding of the problems and prospects in this new aspect of fiscal policy that we hold these hearings.

The subject of these hearings is the prompt adjustment of the Federal deficit through changes in revenues for the purpose of adding to or subtracting from total demand for output. At present, quite prompt adjustment is secured through the operation of automatic stabilization. One question is whether in the very short run these automatic adjustments need to be supplemented by discretionary changes in revenues and expenditures?

If the answer to that question is yes, then a second question of the adequacy of conventional processes for making discretionary changes arises. Discretionary budget changes, it is alleged, are subject to a number of delays: time to recognize a need for action, time to make a decision about the appropriate action to be undertaken, time to implement that decision, and time for the action to become fully operational on private demand for output.

Overcoming the recognition lag is a matter of more timely publication of economic data and better forecasting. With such we are not concerned. Rather, our focus is upon the combined decision, implementation, and operational lag. Almost everyone seems to be agreed that the time consumed in making expenditure decisions and implementing them in general renders expenditures an inappropriate instrument of shortrun stabilization.

We are left, then, with revenues. Do we need to and can we shorten the time required to make decisions on changes in revenues, and what can be done to reduce the delay between recognition of a need for action and its ultimate effect by choosing to make changes in those taxes which have short implementational and operational lags?

As always in inquiries of this sort, we shall ask more questions than we can answer concerning the impacts of tax changes on particular groups of taxpayers, types of income, and kinds of outlays. What are the implications of making shortrun stabilization tax changes fall mainly on investment rather than consumption? Should these changes be directed at property or labor income? Should the changes fall more heavily upon the rich or the poor?

Evidently we have work for able hands, so we would like to hear from all of you.

You may begin, Mr. Brazer, if you would like to, and we will hear from all four panelists and then ask you questions.

STATEMENT OF HARVEY E. BRAZER, PROFESSOR OF ECONOMICS AND RESEARCH ASSOCIATE, INSTITUTE OF PUBLIC ADMINISTRATION, THE UNIVERSITY OF MICHIGAN

Mr. Brazer. Madam Chairman, Senator Proxmire, I am pleased to have been asked to appear before you this morning, and would first like to read a short statement that I have prepared.

My position on discretionary flexibility in tax policy as a major shortrun stabilization device is based on a series of premises. They are:

(1) Monetary policy may be effective and available for combating inflation, but it is likely to be less effective in an antirecession role and, as long as we remain in a balance-of-payments bind, it cannot be used freely for this purpose. In any case, it would seem unwise to rely upon monetary policy exclusively.

(2) Expenditure policy should be governed by our collective preferences for public versus private goods and services. It involves continuing commitments and should turn on issues that are more or less unrelated to shortrun swings in the level of economic activity.

(3) Basic structural changes in tax policy are appropriately made in the pursuit of longrun growth objectives, tax equity, efficiency in resource allocation, and income distribution considerations. The issues involved necessarily are such as to require extensive analysis and debate. They are generally not peculiarly related to shortrun fluctuations in prices, output, or employment.

The suggestion that the investment tax credit might be used as a countercyclical tool has some initial appeal. But consideration of the planning and production periods involved in investment, the desirability of minimizing uncertainty, questions relating to the treatment of outstanding investment commitments, and such features of the law as the carry-back and carry-forward of "excess" credits, and the fact that the credit is allowed when the eligible asset is put in service, rather than when orders are placed or funds spent, all argue against it.

(4) The efficacy of discretionary tax flexibility depends in large part on our ability to make reasonably accurate forecasts of the level of economic activity. In recent years economists have demonstrated that shortrun forecasting can be impressively accurate.

My colleague, Professor Suits, for example, for the 4 years 1961 to 1964, succeeded in forecasting GNP—in real terms—within $2 billion of the actual outcome. Even for earlier years, going back to 1953, and for 1965, when the automobile industry fooled almost everybody, while his forecasting error was typically larger, he never failed to predict correctly the direction of change in total output.

From these premises, I conclude that shortrun changes in tax rates can and should be relied upon as a supplement to built-in flexibility in taxes and expenditures and monetary policy in our efforts to avoid or minimize recessions and inflationary booms. As I see it, the question to be answered is not whether it would be desirable to employ discretionary tax flexibility for this purpose, but, rather, what form should it take and what are the ground rules under which it should operate? More specifically, which tax rates should be varied and in what manner, and what means of implementation might be used?

Most discussions of discretionary tax flexibility have focused on changes in the individual income tax rates. At current levels of income an across-the-board change of 1 percentage point will increase or reduce disposable personal income by about $2.5 billion; changing each rate by 5 percent will affect the tax yield and after-tax income in the same amount.

It seems reasonable to expect that the effect on consumption of a temporary change in individual income tax rates may be smaller than the effect of a permanent change. But while most consumers may not commit themselves to major changes in their spending behavior in response to a temporary tax change, neither are they likely to adjust contractual or semi-contractual savings obligations. And many households may even take an "easy-come easy-go" attitude toward a temporary tax cut and consume a larger proportion of it than they would of a permanent tax cut.

I should, therefore, expect that the difference in the effects on consumption of temporary and permanent tax changes is not likely to be large. Thus, even comparatively small variations in tax rates are likely to produce substantial effects on aggregate demand, equal to perhaps one and one-half to two times—including multiplier effects—the amount of the change in tax yield. Discretionary rate changes designed to provide a swing of $20 billion in tax yield, from plus $10 billion to minus $10 billion, can, therefore, be a highly potent countercyclical policy weapon. They could be effected either by raising or lowering the rates applicable to taxable income by 4 percentage points, that is, from a range of 10 to 66 percent to one of 18 to 74 percent, compared to the current 14 to 70 percent, or by raising or lowering everyone's tax liability by as much as 20 percent, in effect providing rates of 11.2 to 56 percent at the minimum and 16.8 to 84 percent at the maximum.

The choice between these two alternative methods of adjusting tax rates is not obvious. I assume that for the purpose at hand the form of adjustment desired is one that is neutral with respect to the distributional impact of the income tax. But neither of these alternatives is neutral in this sense.

If, in fact, neutrality is regarded as of overwhelming importance, we should have to resort to changes in individuals' tax liabilities arrived at by providing an abatement or increase in tax equal to a uniform percentage of after-tax income, approximated perhaps by applying this percentage to adjusted gross income less "normal" income tax liability. This approach may well be regarded as excessively complex, however, and the question at issue, then, is which of the other alternatives is preferable.

For the equal percentage point change, it may be said that it leaves undisturbed the rate at which marginal or bracket rates advance with rising income. On the other hand, it changes relative tax shares, whereas the equal percentage change in tax liability leaves such relative shares constant. Obviously, for tax increases to combat inflation, lower- and middle-income people will prefer the equal percentage of tax liability approach, higher income people the equal percentage point increase, while the reverse will be true with respect to tax reduction in the face of actual or impending recessions. The issues, it seems to me, are clear, but the answer is not. While the across-the-board percentage point change in tax rates has some appeal because it appears to be neat and simple, requiring no dangling fractional rates, this does not seem to me to be a compelling reason for accepting it or rejecting the alternative.

As a matter of fact, I might suggest that the existence of dangling fractional rates might be helpful, because it would by itself imply or reinforce the idea that the change is temporary.

It seems impossible to avoid the question of whether or not discretionary tax flexibility should encompass the corporate as well as the individual income tax. My own view is that temporary adjustments in the corporate normal tax rate of 22 percent and the 26 percent surtax on income in excess of $25,000 are unlikely to have a major impact on business investment spending or dividend policy. As a political matter, however, I should imagine that it would be difficult to raise or lower tax rates applicable to individuals without taking similar action with respect to corporations. I do not believe that the issue is of sufficient economic importance, one way or the other, to permit one's preferences to stand in the way of congressional action on or public acceptance of discretionary tax flexibility.

The magnitudes involved amount to some $700 million per 1 percentage point change in the tax rates or 4 percent change in tax liabilities. For reasons set forth briefly in my statement of premises, I do not favor temporary structural changes in the taxation of corporations or business in general.

None of the other Federal taxes—excises, payroll, and wealth transfer taxes—lends itself to discretionary flexibility. And while I believe that a new tax, such as a tax on value added, which an increasing number of economists are now advocating, could have some interesting implications for longrun growth and efficiency in resource use and allocation, it should not be permitted to intrude into the discussion at hand. Rather, it deserves a place in any debate on permanent structural reform of the tax system, a debate which, if ever undertaken, will certainly be an extended one.

Finally, the stickiest problem cannot be ignored even in the course of these brief remarks. Who is to exercise the discretion to change tax rates and how is timely action to be achieved? Desirable as it might be from some standpoints, I cannot imagine the Congress being willing to delegate the authority to raise or lower tax rates to the President or any executive agency. It has too often been assumed that Congress is incapable of quick action. The fact is, of course, that it has never been asked for a temporary, countercyclical increase or decrease in tax rates.

It was asked in January, of course, of this year, for quick action on some other aspects of the tax structure, designed to be of a countercyclical nature, and as of yesterday, it certainly proved that it could deliver within the time requested. The President asked for action on the tax bill by March 15; the President signed the bill on March 15.

The approach that appears to me to make most sense and be most likely to prove acceptable is one under which the Congress, perhaps by amending the Employment Act of 1946, would first set out the ground rules for discretionary tax flexibility. Then, each year, or more frequently if requested to do so by the President, the Ways and Means Committee of the House and the Senate Finance Committee would hold hearings on the desirability of a temporary tax change. These hearings could be reasonably brief, since only the amount, not the form, and rarely, if ever, the direction, of the change would be at issue.

Experience with the Excise Tax Reduction Act of 1965 is encouraging, for it demonstrated that when the basic principles of the legislation had been thoroughly discussed in the committees the previous year, Congress was able to take final action in less than 60 days after receipt of the President's recommendations. I see no reason why a similar technique could not be used to achieve discretionary tax flexibility while avoiding infringement of the traditional prerogatives of the Congress. Certainly it would be desirable to begin hearings this spring before the Ways and Means Committee on a "ground rules" bill.

I think it is somewhat premature, perhaps, to ask the question now: Should or should we not have a tax increase at this moment? I think that we certainly should begin hearings on the question of how and when tax flexibility, discretionary tax flexibility, might be employed in this kind of situation.

Thank you very much.

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

Mr. Brown?

STATEMENT OF E. CARY BROWN, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. BROWN. Madam Chairman, and Senator Proxmire, the period following World War II has been remarkably stable in the United States, attributable in no small part to a wiser use of fiscal and monetary powers than had previously been the case. Nevertheless, this performance could have been improved upon: there was a good deal of output irrevocably lost through weakness in total demand; preventable price increases took place that haphazardly redistributed incomes. In this period the great strength of built-in fiscal stabilizers was revealed, but we also observed the relative inflexibility of discretionary fiscal policies. Monetary policy, on the other hand, was used with increasing flexibility after the accord. But while money can be readily manipulated, the spending response to its variation appears to be much slower than the reaction of spending to fiscal changes. If greater flexibility can be achieved on the fiscal side, such a step will add immensely to the power of our stabilization techniques.

IMPEDIMENTS TO FLEXIBLE FISCAL POLICY

A review of the past leads me to the following conclusions regarding the impediments to flexible fiscal policy:

1. The public accepts the need for flexible monetary policy, albeit with inadequate understanding. But understanding and acceptance of flexible fiscal policy, particularly flexible tax policy, is sadly lacking. Fiscal policy should not be considered a failure, as I am afraid it sometimes is, simply because tax rates are lowered one year and raised the next. Indeed, if such changes produce greater stability, they should rather be considered a success.

2. The view that tax schedules are largely fixed, or should seldom be changed, forces inflexibility on Government policy. If fiscal action is thus made essentially irreversible, one is much more cautious in taking it. There is a tendency to wait until there is reasonable certainty that the action is absolutely necessary and will not have to be re-

scinded; yet small steps taken early may provide much more stability than large ones taken later.

3. The inflexibility of tax policy would not be fatal if other stabilization techniques were available; but the flexibility of monetary policy has been inhibited by our balance-of-payments deficit. On the expenditure side, there are serious limits to the achievement of stabilization through its manipulation. Matters of efficiency in governmental activities sharply restrain the degree to which expenditures can be varied, and the overall contribution they can and have made is minor.

4. The speed with which Congress can act on fiscal legislation is adequate for stabilization purposes, provided the tax changes are simple and do not involve substantial technical detail or redistribution of income. There is lengthy consideration, as there should be, when a substantial rearrangement of the tax burden is involved—or a redefinition of the tax base.

5. If we could make lengthy and accurate forecasts of deficient or excessive demand, the rigidity of the stabilization tools would not matter. Short-term forecasts are improving in quality all the time. Economic intelligence and economic analysis have been growing. But there is, as yet, no way of anticipating major changes in governmental programs, especially those related to defense activities, and these exercise an often pervasive influence on economic activity.

CRITERIA FOR THE DESIGN OF FLEXIBLE TAX CHANGES

By drawing on our experience from the past, certain criteria for flexible tax changes seem evident.

1. The form of the stabilizing tax change should be agreed upon in advance, both by the administration and by Congress; to that the only legislative issue would be the need for action, not the nature of it.

2. The stabilizing tax change should be simple in form; so that it can be enacted speedily, and easily placed in effect. It should be readily turned on and off.

3. The stabilizing tax change should have minimal redistributive effects, so that the issue of general structural reform or rearrangement of tax burdens would not impede prompt action.

4. As a corollary of 3, the stabilizing tax change should be thought of as a temporary deviation from the longer range tax structure. A large shift in governmental expenditure policy, brought about, say, through shifts in defense activity, should, therefore, involve a new long-range tax structure. It would not be the province of the stabilizing tax change to cope, except on a temporary basis, with a major shift in governmental activity.

5. The stabilizing tax change should be of a type that will elicit prompt reaction in private spending decisions. Speed of spending response is of more importance than any other single criterion.

6. Perhaps the greatest area of controversy given tax changes that will affect consumption or investment with approximately equal speed is whether policy should aim at manipulating consumption or investment, or both. On this issue, I would favor moving on both fronts, with my primary target consumption. This conclusion is not a matter of principle, but is based on the greater certainty that consumption

can be affected by tax changes. After we have had flexible fiscal policy for a while, the knowledge we would gain from its use might result in a reversal of this position.

Consumption, especially of nondurable goods and services, is a passive factor in the business cycle. Relative to income, it fluctuates considerably less than investment expenditures. It would be desirable to adopt any tax device that reduced the instability of investment. However, major fluctuations in investment are in inventories, and we have not yet developed fiscal devices that can deal with these large shifts. Monetary policy operates more heavily on investment expenditure decisions than on consumer decisions, and in this area acts on a wider front than fiscal policy. Nevertheless, there is a case for buttressing monetary policy by fiscal action, if there are fiscal techniques that might affect investment decisions more promptly and more sharply. Because there may be some controversy regarding this view, I have separated the discussion below between flexible tax changes that would primarily affect consumption and those primarily affecting investment.

FLEXIBLE TAX CHANGES AIMED PRIMARILY AT CONSUMPTION

It would be impossible, and not particularly helpful, to track through all conceivable tax adjustments that could affect consumption. Since a number of them can be rejected as of, at best, academic interest, I will focus on what I believe to be the major candidates for countercyclical manipulation.

A(1). Personal income tax: Form of adjustment

The obvious tax one thinks of for stabilization purposes is the personal income tax. It is broadly based, has a large revenue yield, and can be implemented on short notice through changes in withholding rates. Liabilities can be appropriately modified in April following the year in which changes have been enacted, depending upon the length of time the changes have been in effect.

The question arises as to the form the temporary change should take—exemptions and minimum standard deduction or tax rates. From an economic viewpoint, this is not a particularly important matter. Any of these changes, given equal revenue, would have approximately the same effect on consumer spending. I would reject the cyclical manipulation of exemptions or minimum standard deductions because it seems to me advantageous not to have filing requirements and taxability vary from period to period. This would create a source of confusion to the public that seems unnecessary.

I would rather vary tax rates, and here there are a number of alternative ways of doing it. The particular form, however, is not a crucially important matter, but it should be settled in advance. Changes in rates that would have the least effect on the preexisting distribution of taxable income would be to change each taxpayer's tax rate by a constant percentage of taxable income after taxes. This would result in a change in the tax schedule of more percentage points at the bottom than at the top. There are others who take the view that rate changes should result in an equal percentage change in tax liabilities, and this would involve a smaller percentage point change at the bottom than at the top.

My own view is that it would be somewhat simpler to have equal percentage point changes in all brackets. This has the appeal of mediating between the two opposing views above and allocates to the lower brackets a somewhat larger change in taxable income after tax. Since exemptions are more important at the lower and than the upper, this method comes closer than the others to maintaining the preexisting distribution of disposable income after the tax modification.

A (2). Personal income tax: Effects on spending

On the basis of past experience with personal income tax changes that were believed to be permanent, consumers appear to have reacted to these changes in the same way as they do to any change in disposable income. Moreover, consumers' speed of response is such as to provide prompt changes in consumer expenditure.

A high estimate would place the change in consumer expenditure at about half the ultimate change in consumption—assuming, for analytical purposes, no increase in investment—by the end of the first quarter of a tax change, and by two-thirds of the ultimate gain by the end of the second quarter. A low estimate would indicate a path about half as fast—around half of the ultimate change after two quarters, and two-thirds of the change by the end of a year. These relationships bracket the behavior of consumers with respect to the tax cut of 1964–65; the faster of these relationships slightly overestimating their behavior and the slower one slightly underestimating it. While the results are tentative, the fact that in two quarters a tax change can give rise to approximately an equal change in consumption, is a finding of some interest and hope for fiscal policy.

But, and here I must express less optimism, we are not sure that consumers will respond this way to temporary tax changes. We have only had experience with permanent ones. There have been attempts to close this gap in our knowledge by reference to a relatively few episodes in our recent economic history. Some believe that temporary cuts will have a considerably weaker effect. Others believe that they will act nearly as strongly. One must be an agnostic about this matter until we have more actual experience with temporary tax changes. If they turn out to be weaker than permanent changes, stronger dosages may be required or a different form of temporary tax change proposed.

B. Consumption tax changes

Should it turn out that consumers have a weak reaction to temporary income changes induced by personal income taxes, it may then be necessary to develop a consumption tax that can be varied countercyclically. While it may be possible for consumer units in their consumption decision to ignore temporary income tax changes that balance out over a cycle, the same sophistication would lead them to respond to temporary variations in consumption taxes. For, by paying close attention to these taxes and properly timing their purchases, they could increase substantially their real purchasing power. Their incomes would buy many more goods if they judiciously manipulated consumer purchase inversely to the business cycle. It would pay consumers to behave in this way whether the variable tax was on total consumer goods or was limited to postponable consumer goods, such as durables. Since we do not at the moment have any substantial consumption taxes left, I must emphasize that this problem is not one to be worried about until we find that income tax variations are inadequate to induce consumers to reshuffle their expenditures.

FLEXIBLE TAX CHANGES AIMED PRIMARILY AT INVESTMENT

Should the thrust of countercyclical tax policy be aimed at investment expenditure, three devices suggest themselves: depreciation modifications, corporate rate changes, and variations in the investment credit.

(1) Variations in depreciation techniques seem singularly inappropriate for countercyclical purposes. Depreciation procedures under the income tax are best thought of as a way of more precisely determining taxable income. If that is the case, the definition of income can hardly be thought of as something that varies over a business cycle. I would not, therefore, be in favor of manipulating these allowances in order to accelerate or decelerate business investment decisions.

(2) Corporate income tax rates can also be readily manipulated along with those under the personal tax. I would be skeptical of the desirability of this kind of change, because business investment is relatively long term and would be unresponsive to temporary variations in these rates. Even when the change is considered permanent, this device seems an inefficient one for encouraging or discouraging investment activity. Income tax rates apply to existing investment as well as new investments. The leverage they exert on the investment decision is, therefore, modest. Nor do I see any important reason, in terms of equity, for corporate rates to be manipulated simply because personal tax rates are. These are temporary taxes, and, therefore, they need not be judged in the same way as are permanent changes.

(3) The investment credit, however, seems to be a powerful technique for inducing a change in the timing of business investment in machinery and equipment. It can be made to apply only to new investment. The Presidential tax message of 1961 favored it as a device for stimulating investment for the long pull. As a cyclical device, its advantage over alternative procedures would be even stronger. Its use in this way, however, should not be misconstrued as a change in attitude toward stimulating the long-term growth of the economy, a policy toward which the investment credit was directed. Given the long-term slant toward stimulating investment, variation in the credit would merely mean a hastening or a slowing, as stabilization needs demanded, toward this long-term goal.

(4) There are some technical problems that arise in the manipulation of the investment credit. At the present time it is granted upon the installation of eligible assets. To contribute toward stabilizing demand, it should probably be placed on orders, since these have more effect on economic activity than the act of delivery. Whether or not the Treasury could operate a variable investment credit that depended on when an order was placed is a question you might put to them. But a device that would reduce an expansion in upswings and increase demand in downswings should make a genuine contribution to economic stability.

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As with excise taxes, variations in the investment credit might result in business speculation about the timing of the credit. There would be some tendency to accelerate orders when demand was brisk and legislation contemplated, and a deceleration when demand was weak and an increase in the credit expected. This kind of speculation may certainly exist, but I would not expect it to be of great magnitude. It may simply be a small cost we must accept for this overall contribution to stabilization.

As an order of magnitude, one might think of variations in the investment credit equal to 1 percentage point for each 2 percentage points in the personal income tax rate. Thus, if a variation of 2 percentage points in the personal income tax were made—about $5 billion—the corresponding variation in the investment credit would be 1 percentage point. Should this prove to be ineffective, the gear ratio could be stepped up to a 1-to-1 basis, or even higher. In terms of the last reduction in the personal income tax, this would have meant increasing the investment credit to something like 10 percentage points. Unfortunately, it is impossible to estimate its quanitative effect with the same precision as the personal income tax.

CONCLUSION

In brief, therefore, I recommend the countercyclical use of the personal income tax through variations in its starting rate in order to affect consumer expenditures. I would not vary corporate income tax rates, but instead would cyclically modify the investment credit in order to stabilize certain purchases of machinery and equipment.

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

Mr. Buchanan?

STATEMENT OF JAMES M. BUCHANAN, PROFESSOR OF ECONOMICS, UNIVERSITY OF VIRGINIA

Mr. BUCHANAN. Thank you, Madam Chairman; Senator Proxmire. I might say that due to other commitments, it was necessary for me to prepare my remarks before I received your written announcement, so my remarks might not follow as precisely as they might the outline suggested.

I shall present my views in four parts. First, I shall discuss the desirability of current 1966 tax adjustments, as a means of forestalling undue inflationary pressures in the national economy.

Second, I shall discuss the general question of the desirablity of introducing automatic or quasi-automatic tax adjustments for the accomplishment of stabilization purposes.

Third, I shall examine the relative advantages of various tax instruments for this objective, on the assumption that such automatic adjustments are introduced.

Fourth, and finally, I shall discuss the possible shift of tax-adjustment responsibility from the Congress to the Executive.

(1) Since mid-1965, the national economy has been excessively stimulated by the monetary-fiscal policy combination. As a result, there now seem to be strong inflationary pressures in the economy.

It is absurd to expect to and dishonest to pretend to deal with inflation by exhortation, by reliance on so-called wage-price guidelines. And it would be tragic to move in the direction of wage and price controls, which, at their best—as with wage-price guidelines—can only repress inflation. It is irresponsible to blame labor and business for what is essentially, and necessarily, governmental policy.

It is almost impossible to separate fiscal and monetary effects, and fiscal policy and monetary policy must be considered as a unit. Currently, within the last 1½ months, Federal Reserve policy seems to have shifted, belatedly, from one of monetary ease to one of monetary restriction, although this may, of course, be reversed at any time. In the current setting, monetary restriction should be continued, but additional fiscal adjustments may also prove desirable. If they do, first priority should be given to reductions in nondefense spending rates, and notably to those programs that had their initial impetus in an allegedly depressed national economy. If substantial budgetary cuts are made, tax adjustments should not be required at this time.

If tax changes are considered to be necessary, some economists have recently proposed a repeal of the 7-percent investment credit as a means of reducing projected capital spending by business firms. I should support this proposal, provided that the repeal is a permanent one. There is no place in the tax structure, individual or corporate, for adjustments that differentially reward and differentially punish particular sorts of behavior. If 1966 affords an opportunity to repeal the investment credit, this opportunity should be taken. Since 1962, my concern has been that this credit was only the first of a series of gimmicks designed to employ the corporate tax structure as a means for making business firms do what Washington wishes. If, on the other hand, the proposal is to repeal the investment credit temporarily with subsequent reintroduction of the credit when current emergency conditions no longer exist, I should strongly oppose this. The investment credit should either be a part of the tax structure or it should not. It is not an appropriate device to be turned on and off for shortrun stabilization purposes.

If tax increases are considered to be necessary, but temporary, such increases should take the form of across-the-board, equal-percentage changes in personal income taxes. All taxpayers should be required to pay an additional percentage of their current tax bills.

The fiscal effectiveness of any temporary tax changes can be questioned on familiar grounds. This has already been referred to by Professors Brazer and Brown.

(2) I do not support a policy of introducing automatic adjustments in tax rates, adjustments that might be tied to specific economic indicators, such as unemployment or price indexes. This is in spite of my strong support for some overall rule for monetary-fiscal policy, some rule that should be predictable in advance. As suggested, fiscal and monetary policy cannot really be treated as two separate and distinct instruments. In view of this fact, it is not reasonable to introduce rules for fiscal policy in the absence of rules for monetary policy. It is possible that such rules would do more harm than good, and that they would generate either overadjustment or underadjustment to the particular situations in the light of either conflicting or complementing monetary policy.

I support a rule for monetary-fiscal policy that concentrates attention on the rate of change in the monetary stock, currency in circulation plus demand deposits. If a rule could be introduced that requires the Federal Reserve authorities to insure that the rate of growth in the monetary stock approximates the rate of growth in national output, fiscal policy—in the sense of manipulated changes in tax and spending rates—could be relegated for use only in extreme emergency situations. This rule would, of course, allow for Government budget deficits, if it is determined to be desirable that additional monetary resources be injected into the economy through the budget. This rule would, also, remove the inherent conflict that arises from the independence of the Federal Reserve Board. This rule would allow Congress to lay down in advance its own objectives for stabilization and economic growth.

3. If automatic or quasi-automatic adjustments in tax rates are to be introduced, these should be across-the-board adjustments in personal income taxes. Specifically, these should take the form of proportionate changes in taxes for all taxpayers. This scheme, and only this, will preserve the structure of progression in the income tax. The progressivity here should not be modified by temporary shifts in rates, but should, instead, be determined by the Congress in periodic long-range tax reforms.

In effect, only through proportionate changes in rates can individuals, along the income scale, be maintained in positions where they will pay the same relative shares in the costs of Government before and after adjustments. Proportionate changes in rates for shortrun stabilization purposes can be introduced by allowing simple computations on the part of individual taxpayers, and without major changes in IRS rules or forms.

For example, if required, all taxpayers can be forced to add an additional 5 percent to their tax bills when the rate of price inflation exceeds x percent, or, conversely, to reduce their computed tax bills by 5 percent when an unemployment index exceeds x percent. These changes can also, of course, be handled readily via the withholding mechanism.

4. The Commission on Money and Credit, in 1961, advanced the proposal that the President be granted power to modify first-bracket income tax rates within certain limits in order to promote shortrun stabilization objectives. In testimony before this committee at that time, I opposed the grant of such additional power to the Executive. My argument was based on the view that the Executive would be no less immune to political pressures than the Congress, and that such additional tax adjustment power would likely be used in a biased manner.

My position remains unchanged from my earlier testimony. The Executive currently has ample power to promote stabilization objectives—if it desires to do so—through its controls over the rates of public spending, and Congress has shown a willingness to consider, if and when required, changes in tax rates. In fact, my general position in opposition to this additional grant of power to the Executive, is stronger today than it was in 1961, since surely we have witnessed, over the period since that time, a substantial and in my view, dangerous, reduction in the relative power of the Congress at the expense of the executive branch of government. Any further shift of this power to the Executive should, in my opinion, be strongly opposed by the Congress.

Thank you.

Representative GRIFFITHS. Thank you very much. We will be pleased to hear from you, Mr. Harriss.

STATEMENT OF C. LOWELL HARRISS, PROFESSOR OF ECONOMICS, COLUMBIA UNIVERSITY, AND ECONOMIC CONSULTANT, TAX FOUNDATION, INC.

Mr. HARRISS. Madam Chairman, Senator Proxmire, the invitation extended to us included so many points that none of us could cover them. My prepared statement, which you may wish for the record, discusses more than I wish to comment on now.

I think prompter fiscal and monetary action for stabilization purposes are desirable. The delays which have occurred since the war have brought needless and excessive wastes. Nevertheless, conditions do not seem to me as urgent as is sometimes implied. Therefore, the need for a formula-type or automatic actions appears to me somewhat less than would be the case if we felt that cumulation, a self-generating movement once started, would feed on itself and thereby develop into "boom and bust" type cycles.

In discussing the possible changes to meet the needs of more or less "normal" economic fluctuations, it is important to recognize that the causes of trouble are likely to be complex, differing from time to time. Even though we know something about the direction which desirable action should take, we are much less likely to know either the amounts or the probable duration. Moreover, any general fiscal action must consist of particular parts. Some combinations of parts will be better than others. Some may be worse than no action at all. Either a general rule set in advance or the grant of discretion within certain limits now seems to me less desirable than undesirable. Given the present state of our knowledge, on earlier occasions, I recognize, I have favored discretionary power to act which now strikes me as less promising than temporary action taken in the light of conditions as they develop.

Advance discussion and even agreement on the kinds of tax changes would be desirable—but not fixed rules. The paper lists several reasons for my reluctance to favor rules set in advance. Under present conditions, incidentally, if the President or some group had power to raise tax rates, any inclination to reduce the growth of expenditures would be substantially weakened.

The chief argument against giving discretionary authority or the setting of rules to alter taxes is that monetary and fiscal policy are inevitably intertwined.

To try to set fiscal changes in advance without knowing what the monetary policy will be misdirects effort. The results that will prevail must consist of the outcome of what happens in both fiscal and monetary spheres. The economy cannot have a fiscal policy, fiscal policy action, which does not affect the use of money in society—perhaps just the substitution of one use of money for another, but possibly be a change in the stock of money or a change of the rate of turnover velocity. Every business day the Federal Reserve operates in the monetary sphere, directly and indirectly.

Both monetary and fiscal policy are always acting. Although for purposes of analysis or discussion we assume ceteris paribus, and talk about one policy or another, such separation is not the way that the real world functions.

You must feel a sense of frustration to listen to monetary economists and what appears to be a wide range of different opinions. The framing of forward-looking policies however, must take both monetary and fiscal policies into account. A serious gross oversimplification is quite common today in evaluating the effects of tax changes in the early and mid-1960's. What has happened in the economy is attributed, perhaps only by implication, to tax changes; a look at what has happened in the monetary sphere would indicate that monetary changes may also have been effective, exerting a powerful expansionary influence.

Causality is difficult. Nevertheless, in trying to plan broad economic policy, certainly one direction of improvement must be the development of better methods of cooperation and coordination in the formulation of both fiscal and monetary policies.

You know how fiscal policy is made, including the decisions on expenditures. We have some idea about who makes monetary decisions; there are influences of many types, including some over which none of us, apparently, can have much control, such as foreign central banks and balance-of-payments considerations. Yet in any case the American people have a right, justifiably, to better coordination between the people who make decisions on monetary policy and those who make decisions on fiscal policy. One of the requirements is better information. As Mrs. Griffiths remarked, information is much better than in the past, thanks in part to this committee. Still, there is a role for effort to provide better information and improve its use. Congressional hearings like this certainly have a very important role to play. They suffer, unfortunately, from certain limitations as a method of communication.

A possible supplement might be the improvement of the contacts between professional staffs of the congressional committees, the executive agencies, and the Federal Reserve. Present procedures are not exactly clear to me, but I have an impression that potentialities for improving the basis of decisionmaking certainly remain to be cultivated at the staff level. I emphasize staff for various reasons stated in my paper. Some kind of continuing, more or less regular, threshing out of issues at the staff level might offer some possibility of improving the basis for decisionmaking.

Another requirement is better knowledge about the entire fiscal situation, including expenditures as well as taxation. You know how uncertain is our knowledge about what is really coming in Federal expenditures. Spending decisions are made by a process which apparently gives no appreciable consideration to the aggregative effect. Action is taken on particular programs, not on the whole.

The various suggestions for altering procedures for determining expenditures may or may not be feasible. Perhaps none would be truly constructive. Nevertheless, they may be worth considering, as a part of better management of fiscal policy. Other complications include the various Federal credit policies.

The invitation included requests for suggestions about more specific things. So far as purely countercyclical actions are concerned, my paper includes a few comments which in general are fairly consistent with what each of the other panelists has said, except that I would not be inclined to try to utilize the investment credit. I join Professor Buchanan in suggesting that it be replaced by a general reduction in the corporation tax rate when change of such a type becomes possible. However, these are issues that I simply do not have time to discuss.

Dollar for dollar, it is frequently said, Government spending has a greater influence upon jobs and the price level than do taxes. Perhaps this is true. In any case, expenditures do have an important force. They are not suitable, by and large, for shortrun countercyclical action. Every year, however, the Congress has before it some major changes in nondefense spending—that is, proposals for major changes—these may include the scale of existing programs, the adoption of new programs. There will always be some opportunity for judging these in the light of the current fiscal outlook. And at some times we are better able than at others to afford increases in governmental spending. The higher the boom, as noted in my paper, the less we can afford.

At the moment, the fiscal problem is one of upward pressures on the price level. Government expenditures can be influenced with this in mind. A few points can be made in this connection.

Try to find those types of Federal expenditures which raise costs and prices more than insignificantly where the spending is made—notably construction; but there may be other cases. Perhaps then Congress could make a concentrated effort to restrain the growth of such spending. Delay can offer a little leeway for easing near-term pressure on the economy, without necessarily abandoning undertakings. Postponement of new construction, if only for a few months, would relieve some immediate pressures.

The present budget includes expenditures proposals which were made many months ago, when it was presumably assumed that no increase in tax rates was called for. If there is now need for an increase in tax rates, some of those programs are probably not justified, at least on the ground of the original decisions. The rise in market rates of interest creates a presumption that some long-term projects would not meet the criteria of acceptability at this time.

Insofar as pinpointed tax changes are concerned, to try to design a tax increase or tax reduction for a specific purpose in mind seems unwise, although this kind of proposal is likely to seem tempting. What really influences investment, for example? Is it something like a change in the investment credit or a change in consumer demand? Specific tax changes are to be avoided, as a general rule, and for macroeconomic effects reliance is better placed on broad actions.

You asked us to comment upon the concept of neutrality, which is apparently favored by the Treasury. Our immediate situation does not seem to me so urgent but that we can use the opportunity for tax changes to try to improve the tax structure. This may not always be the case. If not, then probably the most desirable kind of change is an equal proportionate change, either in rates or percentage of tax. I have no strong view on this point at the moment.

One thing, however, seems clearly desirable—always to try to make any change something that we would like to live with forever, or as far ahead as we can see. For temporary changes, of course, this is not always feasible. Yet temporary things have a record of lasting a long time. And the clearer our concept of the kind of tax system we would like to leave to our children, the better the guides for making decisions, even though they may appear to be temporary decisions. My views and prejudices on this are included in an attachment.

The corporate tax rate is not something to be manipulated, except downward. Over time, corporate tax rates should be reduced. For political reasons, such action may not seem fully acceptable. Whenever tax reduction is possible, the occasion should be used to get the corporate tax rate down to a more satisfactory long-term level. When a boom is to be checked, however, increases work against our longrun welfare.

Thank you.

(The prepared statement of Mr. Harriss follows:)

Prepared Statement of C. Lowell Harriss

FISCAL ACTION TO INFLUENCE EMPLOYMENT AND THE PRICE LEVEL

(Views expressed are my own and not necessarily those of any organization with which I am associated. The Joint Economic Committee's invitation offered opportunity to discuss several aspects of the problem which limits of time have prevented me from even mentioning. Most of the topics I touch upon, including the assortment in footnotes, deserve more exploration than has been possible for this occasion)

The birthday celebrations last month brought well-merited praise for the work of the Joint Economic Committee. The hearings you now undertake will continue a valued practice. Perhaps progress seems slow. In trying to draft some remarks, I kept asking myself, "Haven't they heard this before, many times?" Affirmative answers were usually indicated. But you have also heard things I would never say. So we keep on exchanging ideas and hope that the country will benefit.

Expediting fiscal actions

Why is there concern for speed in fiscal policy actions?[1] We may want speed to meet change which is both sudden and large—the outbreak or ending of hostilities or a big surprise in international affairs. Congress and the executive branch have shown that they can act quickly under such circumstances. Any future case will be sufficiently unique to render general prescription in advance an unpromising use of effort.

Today's concern centers, I believe, upon less extreme cases. One might call them "normal" features of modern life. Yet they may (but need not) differ so much that any term implying uniformity can be misleading. Urgency is not obvious. Is speed of action important?

Two reasons for concern can be distinguished: (1) Delay can aggravate the ultimate problem by enabling processes of economic cumulation to feed upon themselves, to permit spiraling, self-generating, snowballing tendencies—many figures of speech can be used—to get established. (2) Every day of delay in applying an available remedy deprives society of something better.

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[1] "Policy" as used in this paper means what is done, the course of action taken. Ordinarily, there will have been some prior deliberation and more or less conscious choice among alternatives which seem to be means of achieving one or more goals. Intention in itself is not what I mean by policy. The things done and the results have no necessary relation to intent.

Postwar ups and downs in business have been moderate, at least relative to the fears stemming from the great depression. The forces of cumulation have been moderated by automatic fiscal stabilizers and by other factors which in combination seem to provide powerful protection against "boom and bust." To the extent that this is true, the reason to seek speed in fiscal action does not lie in need to protect ourselves against forces which, left to themselves, produce calamitous depression or wildly distorting boom.

The second reason for seeking speed—the reduction of avoidable losses of well-being because of delay in putting better policies into effect—provides ample reason for trying to improve upon achievements to date. Losses have been large.[2] In one respect, lack of urgency can be an obstacle. When almost everyone prospers—or if any impending price-level increase is associated with the attractions of generally rising real income for the majority—can one expect a ground swell of public support for policies to change things? Any obvious benefits might accrue predominantly to others. What reason has one to expect normal inertia to be outweighed by general public pressure for action?[3]

Some problems of action

The less-than-extreme economic illnesses can be of many degrees and kinds. No two can be identical. The causes of trouble, from the easily observed to those never detected, consist of a complex mixture. Even so, however, the broad, aggregative actions of fiscal policy can be helpful, exceedingly so. The direction of desirable action will ordinarily be clear. This knowledge ought to be worth many multiples of the most fabulously rich gold mine.

Unfortunately, gaps in our understanding remain. Neither the optimum amounts nor the duration of a policy will be clear. Overshooting the mark cannot be ruled out nor can undershooting.

Any general policy (macro) takes concrete form only as particular acts (micro). A total of any given dollar amount—the results of a $5 billion change in taxes—may consist of any of several combinations of parts. All combinations may produce results which are better than those with inaction. Some combinations, however, may be much better than others. And some may lead to less desirable results than inaction.[4] Yet our natural urge is for action.

Two approaches to action, I gather, are of special interest in these hearings. One would set a general rule to be applied more or less automatically. The other would grant a significant element of discretion (but within some limits) to a person or a group. You will hear more from other panelists, some of whom will undoubtedly favor the general proposal. My comments will be brief and critical; for despite what I have written on other occasions, the net attractions now seem to me negative.

In the present state of economic knowledge, I doubt that a rule set in advance could be counted upon to do more good than harm as compared with action—or inaction—based on contemporary response to conditions as they develop.[5] The conditions which actually unfold will have elements not foreseen. A rule set in advance would not benefit from the "learning curve" of experience. Congressional and public debate has an educational value. If a general rule, perhaps modified by discretionary power, were on the books, its mere existence might

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[2] What was America's loss of real income by failure to apply the tax-rate reduction medicine of 1964 (in appropriate dosages) beginning in 1958 or even in 1961? The needless loss was probably in the tens of billions. Inevitably, however, estimates which rest on surface observations after the event will not take account of complex interrelations. Nor will intangible factors which may have exerted influence, perhaps a great deal, get their proper attention. For example, did the sometimes mild, sometimes harsh, restrictiveness of monetary and fiscal policy in parts of the mid-1957 to mid-1960 period yield great benefits in the 1960's by exorcising a "psychology of inflation"? Very possibly. If so, post-1960 applications of expansive monetary and fiscal policy have been freer of problems, but how much so?

[3] This consideration may very well add a reason for adopting a rule, some more-or-less automatic guide, for fiscal policy change.

[4] My language employs terms which reflect value judgments. The statements are useless as guides to policy without definition of "better" and "desirable." Economists frequently combine assertions about what can be expected to follow from certain actions with an unstated conclusion that one kind of result is superior to another—jobs versus prices. Choice among goals, however, depends upon value judgments. When relying upon them should we not try to make them explicit and clear?

[5] The wider the tolerances offered—percentages of unemployment or price-level rise—the less the prospect of improving upon what would otherwise be done. Precise, exact standards cannot be imposed without producing strains in implementation which at best would add heavily to real costs and at worst spread disrupting, distorting forces through the economy.

add to delay (compared with what would otherwise occur). And would it not impede adjustment of amounts when the "ideal" seemed to lie beyond the limits? The upward secular trend in revenues creates a presumption that the measure of appropriateness changes. Yet no one can predict the amount without knowing what will happen to spending.

Discretionary or formula-based power to raise tax rates during boom would reduce pressures to restrain expenditures. Endorsing of the principle of setting a rule or granting discretion in advance can trap one into "going along" with compromises which are far from optimum. And what does one know about the men who would have the power and the conditions under which they would make choices? [6]

What reason has anyone to assume that what lawmakers (Congress and the President) enact would approximate the specifications needed for success? Does not experience suggest that a new law might well have some truly bad features? [7]

The job of education—of learning and of teaching—remains formidable. Economists probably do know a great deal. But a little contact with work at some of the frontiers (whether those well beyond our position a decade ago or those not yet pushed back significantly) inspires—compels—caution in prescribing for society in conditions yet to develop.[8] Finally, the effects of any fiscal action will depend upon the monetary conditions under which it will operate, and they cannot be predicted with near accuracy.

INTERRELATION OF MONETARY AND FISCAL POLICIES [9]

Any changes in Federal revenues or spending (fiscal policy action) must be financed. The stream of money payments cannot remain the same. Perhaps the adjustment will be a simple substitution of one use of money for another. Two other possibilities carry more potential "punch"—changes in the stock of money or in the rate of turnover of existing dollars.

Changes in the level of national income depend not only upon fiscal, but also upon monetary, policies.[10] Every business day the Federal Reserve by action (e.g., open-market operations) and by standing ready to act on certain terms (e.g., to lend to member banks at a discount rate announced in advance) influences the money-creating capacity of banks.

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[6] Examination of the record of use of discretion by the Federal Reserve would illuminate some of the problems, but not all. The "Fed" has not faced problems of balancing Federal expenditures against changing tax rates. And the political pressures it has faced hardly compare with those bearing upon elected officials.

[7] In a contest between economists pointing to "errors" in Federal policy (tariff, minimum wage, agriculture, transport, etc.) and Federal officials pointing to weaknesses in the work of economists (I shall not venture to suggest examples) the result might be a standoff. The fallibility of economists is not to be denied. How many of use have been willing to assume that net benefits can be expected from a law bearing a good name and supported by men of goodwill?

[8] Of the many unkowns one may cite the balance of international payments.

[9] Other policies, notably those affecting wage rates, also influence the results. The higher the level of average wage rates, for example, the greater the dollar total of demand needed for any total of employment. The relationship, one often ignored, can be illustrated as follows with an adaptation from a source well known to you. "A GNP of $750 billion would buy 150 billion hours of labor at $4 an hour (leaving $150 billion for other factors). If aggregate demand rises by $12 billion and if this increase all goes to labor, an additional 3 billion hours of employment are created—providing wages remain at $4 an hour. If wages were to rise to $4.10 an hour, however, the $612 billion now available to labor would not even pay for 150 billion hours of employment. Depending upon the cost of labor, as well as other factors, increases in aggregate demand do not necessarily insure more employment." (Joint Economic Committee, U.S. Congress, 1964 Joint Economic Report, minority report, p. 37.) I have updated the numbers. Raising the minimum wage and extending coverage along the lines reported in the press would complicate and aggravate the problems of achieving full employment with price-level stability. The resulting wage-rate structure would obstruct the absorption into the employed labor force of young people and others whose productivity is not yet up to the legal minimum. If the rise in the minimum induces increases above the minimum, the quantity of labor demanded will drop. The rise in wage rates will not, of course, have increased purchasing power; if employees get more, those who pay are left with less. An increase in purchasing power comes from monetary-fiscal actions. They can boost money demand enough to finance the purchase of the original total of man-hours at the higher amount per hour. "Demand pull" and "cost push" combine to make the price level higher than it would otherwise be.

[10] For present purposes monetary policy can be identified with Federal Reserve actions which influence (control) the lending capacity of commercial banks, more specifically the ability of banks to create the demand deposits which constitute most of our supply of money. Relevant also are other actions which influence liquidity but not the stock of money as defined strictly. Deposit turnover is not subject to Federal Reserve control.

Money counts

Both fiscal and monetary policies will aways be operating. Society must manage both all the time. When Federal finances are as huge as they are today, the two types of policy must be intertwined.

Monetary and fiscal policy are by no means perfect substitutes for each other. They are not fully interchangeable. Nevertheless, the effects of any fiscal policy must work out in an environment which depends significantly, so far as concerns changes in national income, upon monetary policy.

Both public debate and advanced professional analysis often benefit from using the assumption of ceteris paribus, other things being the same. Real-world processes, however, do not permit the simplification which involves a fiscal policy change having no monetary effect.

Joint Economic Committee hearings record attempts to get more information and sharper analysis of the monetary aspects of (recent) tax change. Not all of the answers deserve a grade of "A." [11]

Economists disagree in their weighting of the relative importance of monetary and fiscal actions under different combinations of conditions. Specialists in monetary economics will present you with baffling conflicts of view, not only about the importance of monetary policy but even about the processes by which an action of the Federal Reserve exerts its full influence on the economy. Anyone with responsibility for policy has my sympathy when forced to choose among varieties of advice on monetary alternatives. The differences among monetary economists, however, do not justify what sometimes seems to be the denial, by implication, that differences in monetary policy will influence significantly the outcome of fiscal action.

While tax reduction was being considered in 1963 and 1964, little was said about the significance of different possible methods of financing a tax cut. Since then in assessing the effects of the tax cut, many observers have made no explicit allowance for changes in the stock of money and in velocity of circulation. Yet great changes have taken place in both. The compounded annual rate of change in the money supply rose from 1.8 percent (mid-1960 to September 1962), to 3.9 percent (to June 1965), and to 5.9 percent (to February 1966). The seasonally adjusted annual rate of turnover of demand deposits rose from under 30 in 1961 to around 35 in mid-1963 and 51 in January 1966.

These computations are those of the Federal Reserve Bank of St. Louis as summarized in its Review for March 1966. If time deposits were included in the money supply, the increases would be even larger. Deposit turnover figures from the Federal Reserve Bulletin; data before 1964 apply to 343 leading centers; since then computations are for 225 standard metropolitan statistical areas.

Today's concern about the past lies not in what happened but in the interpretations made in the future. Decisionmakers can be misled. If they attribute results of past policies to the wrong balance of factors, are they not likely to select an inferior mix of policies?

Interpretations of the economic sluggishness of the late fifties which focus on fiscal developments seem to me to oversimplify. Growth in the stock of money slowed and for a time even became negative. My point here is not to express a judgment upon the policies of 1959–60 nor of the interpretations made at the time. The objective is to call attention to a gap in present analyses which assign little or no weight to monetary developments.

Who can possibly judge the effects of different possible fiscal actions without making assumptions about monetary conditions? Can one be sure about the degree of accuracy of different possible assumptions? The leaders of our Government have the potential power to assure themselves of a much higher degree of certainty about monetary policy than has been the case to date. Velocity of circulation will remain a variable beyond direct control. But changes in the stock of money—defined as currency plus demand deposits—can be controlled within moderate ranges, not necessarily from week to week but for periods short relative to phases of a business cycle.

Can monetary policy meet the need for speed in action?

To what extent will conditions which seem to call for (speedy) fiscal action be amenable to correction through actions of the monetary authorities? I shall

[11] For balance-of-payments reasons, it is said, one type of policy (fiscal for stimulating the economy, monetary for restraint) should take precedence over another. It seems to me, however, that additional analysis is called for. The links in the underlying chains of reasoning may not always be as strong as implied.

try to hold my breath waiting for general agreement on an answer to this question.

Economists will differ on the effectiveness of monetary policy. Some doubt the desirability of using it, at least under some conditions. My views, with all the hedging you have learned to expect from economists, would put both faith and hope in monetary policy—but not to do all that may be desirable to supplement automatic fiscal stabilizers. Nor do I believe that timing by monetary authorities can and will provide the balancing we may wish for. Yet the reasons which lead me to this conclusion argue with at least equal force against the feasibility of sensitizing discretionary fiscal policy to offset the timing inadequacies of monetary policy.

Improving cooperation and coordination in the formulation of fiscal and monetary policy

Fiscal policy is a means to ends. Monetary policy affects the achievement of the same ends, especially those closely related to the levels of employment and prices. Fiscal policy results from (a) the recommendations of numerous elements of the executive branch, (b) the actions of revenue-raising committees and the Appropriations Committees (and their subcommittees) in both House and Senate, and (c) the Houses of Congress themselves. Monetary policy is made by the Federal Reserve subject to an undeterminable influence from the executive branch, from Congress, from foreign central banks, and from other sources.

As an outsider I cannot evaluate the "real-life" working of these arrangements. But I have read much of what has appeared in print. From it I gain an uneasy feeling. Do the men who make the decisions understand the issues, processes, mechanisms—including the ties between monetary and fiscal policies? The past may be a poor guide to the future. Will not everyone have learned? Unfortunately, some of us are slow learners. Even more to be regretted, the "truth" is not crystal clear.

In any case the public may reasonably expect that the two groups of decisionmakers, using what seems to them the best of insight, coordinate policies. Apparently, however, present practice fails to assure coordination. (I assume that we can take goodwill for granted, a condition necessary but not sufficient for effective coordination.) Perhaps this problem warrants reexamination.[12]

Among the many complications are some which grow out of the existence of numerous Federal programs for granting credit, or assisting private lending agencies to extend credit, for a variety of objectives. Sometimes credit in the form of loans made from the savings which the public makes out of income costs more, the market rate of interest is higher, than beneficiaries of the program expect; perhaps the law has put a ceiling on the allowable interest rate. In such cases the pressure for money creation to provide funds can be strong indeed.

The decisionmakers' need for facts and analysis

The improvement of information available to policymakers represents an achievement for which the Joint Economic Committee and its staff deserve the country's thanks. Unfortunately, more remains to be done in providing evidence about what has (just) happened and in analyzing the probable results of alternative courses of action. Not enough is known, and yet no human can possibly assimilate everything which might be relevant. Major policy alternatives always present uncertainties and risks. Part of any argument for pre-set arrangements to change fiscal policy rests on a belief that "information" and "recognition" lags are greater than essential.

Congressional hearings such as this, as well as those on specific proposals for legislation, advance understanding by witnesses, including academicians and representatives of the executive branch, and perhaps in Congress. Nevertheless, hearings cannot do all that is reasonably possible in threshing out tough questions—and many are tough. Chains of thought get interrupted. Questioning must often break off before the witness and the questioner have exhausted a topic, leaving an impression which may be not only incomplete and inconclusive

[12] If coordination cannot be counted upon, what are the implications? What would be involved in bringing the monetary and fiscal authorities under the same control? How would such change compare in promise, and danger, with a grant of authority for some small group to change tax rates?

but even inadvertently misleading. The public forum, with or without the prospect of going on record, has some disadvantages as a means of examining complex and controversial issues. The insights which come as one travels home cannot get into the discussion when there is no second round. You may with solid reason have doubts about the degree of executive branch and Federal Reserve cooperation. How can any committee of Congress be certain that it is getting the full and complete thinking of executive agencies, with articulation of their doubts and differences of view? Congressional hearings have a less than fully satisfactory record in getting access to the facts and reasoning which account for Federal Reserve actions.

One possible procedure for strengthening the basis for decision occurs to me. Might not the contacts between the professional staffs of congressional committees, executive agencies, and the Federal Reserve be developed more fully? An outsider cannot appraise adequately the extent and effectiveness of present arrangements, formal and informal, for staff discussion, exchange of information, debate. Yet I have an impression that potentialities for improving the bases for decisionmaking remain to be cultivated at the staff level. The emphasis on staff rather than on higher officials themselves rests on more than one consideration. The job requires more time on a continuing basis than Members of Congress and agency heads could find for an added responsibility—not many hours a month but more than busy men are likely to find for what seems nonurgent, and most of the time no element of emergency will exist. Professional economists speak the same language, a fact aiding both the depth of discussion and the dispatch with which it can be accomplished. One meeting could pick up more or less where the last ended, aiding continuity. Policy positions of superiors would probably inhibit frank and scientific discussion less than in other forums.[13] Staff can screen material to pass on to their superiors in Congress or the executive agencies the net results of discussions, along with suggestions for action.

Getting the entire fiscal picture—accurately

Fiscal policy includes spending as well as taxation. Problems of the economy as a whole (macro) require the comparison of (*a*) expenditures as a whole with (*b*) taxes in their totality. January's budget offers the nearest thing we have to a means of doing so. Within days, however, it can begin to get obsolete. For most of the 12 months no one has estimates of the relation of future taxes and spending which are free from a significant range of uncertainty.[14]

Thinking of taxes from the point of the effects of revenue totals on the economy as a whole got support during the 1963–64 discussions of tax reduction. Spending decisions, however, are made by a process which gives no apparent consideration to the aggregative effects, i.e., action is taken on particular programs (in substantive legislation and later in appropriation bills) not on the whole. The individual programs are determined one by one with little explicit regard for their cumulative effect on the total.

Concern for balancing the budget may, or may not, once have had meaningful effect in getting Congress to take account of totals of prospective taxes and expenditures. Be that as it may, I suggest that advocacy of abandoning the balanced-budget guide has strengthened the forces which deprive us of an effective means of determining spending in total in relation to revenue totals.[15]

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[13] Representation of the minority party would be desirable, and probably essential for maximum effectiveness in expediting action; yet there would be problems for which I can suggest no solutions at this time.

[14] Perhaps my statement is too sweeping. Within Federal agencies someone may prepare truly realistic estimates of the best judgment of what is to occur. When a budget contains as many uncertainties as have those of recent years, notably assumptions of actions by Congress which cannot be counted upon, responsible officials presumably insist upon figures which allow for expectations which are not to be made public.

[15] The fiscal policy actions which affect levels of employment and prices are measured significantly by those reflected in changes in deficit or surplus. Debate on the relative worth of different possible budget measures can get into esoteric and complicated issues which are not vital to the point being made here. Small percentage errors in estimates of spending and taxes can be very large in relation to the size of, and even more to changes in, the deficit or surplus. Assume that this year's deficit is $7 billion (1966 cash basis) and forecast to become a $0.5 billion surplus (1967). Total spending is estimated at $145 billion for 1967. A 5-percent error in estimating expenditures, not big in relation to average experience over many years, would be almost as large as the change in the deficit. It would be many times the forecast surplus. If revenues are overestimated and expenditures under estimated frequently but not always the case, two apparently small errors can combine into a total which is large in relation to the net budget result projected or realized.

Might procedural changes enable Congress to consider, and perhaps even act upon, the total of spending decisions as a unit? Some students of the problem believe that such a revision of procedures is not out of the question.[16] One reason for endorsing such action might be the possibility of improving fiscal policy to serve better as an aid for influencing the total level of economic activity.

Other problems call for attention. How do receipts from the sale of assets, or from a speedup in collections, compare in economic effect, per dollar, with tax revenues? What, if any, spending or credit policies are likely to encourage money creation and thus exert more inflation effect than indicated in the budget figure?

WHAT KINDS OF FISCAL CHANGES: OBSERVATIONS ABOUT CHOICES

Suggestions here reflect my own value judgments. Each point would justify an entire paper, or more. Although my comments take account of the immediate prospect, they take account of longer-run considerations and generally pass over details to more general matters.

Purely countercyclical actions

If there is to be fiscal action for purely shortrun countercyclical needs, changes in the personal income tax seem the best. Alternatives are few. Adding and removing excise taxes would involve administrative and compliance problems of some magnitude; changes large enough to bring much revenue would tend to alter the consumer buying timing of enough to be destabilizing. Raising and lowering the rates of existing excises would be administratively simpler but would discriminate among industries and consumers on the basis of consumption patterns, a result which does not appeal to me. (Although I would favor, in principle, the addition now of user charges, whether or not designated as taxes, such action would not be one to be reversed later for anticyclical reasons.) Changing payroll tax rates would involve issues of social security financing, direct additions to business costs, and burden distribution which combine to lead me to oppose such action.

Raising and lowering the corporation tax rate would complicate business management, especially investment planning and in some cases (e.g., regulated public utilities) pricing. The distribution of burden would be—well, what would it be? No answer to the question is clear, a fact which provides one reason for my vote against this possibility. However, I favor gradual reduction of the corporation tax rate over time; therefore, some reduction when economic stimulation is desired seems to me desirable—but not increases. As to the investment credit, I do not see how it could be granted, suspended, granted again, etc., without adding to the instability and giving rise to problems of inequity among companies.[17]

Shortrun changes in the personal income tax, of course, present more than a few problems. Other witnesses, I believe, will discuss the possibilities and problems of anticyclical variation in withholding.

Expenditures

Dollar for dollar, Government spending may, or may not, have greater influence (macroeconomic) upon jobs and the price level than do taxes. The predominant opinion among economists seems to be that spending has more effect per dollar; if so, putting the brake on inflation requires fewer dollars of restraint through the spending than through the taxing route. Moreover, although it may seem paradoxical, the nearer the economy is to full employment, the less its "ability" to "afford" Federal expenditures.[18]

Shortrun expenditures change for countercyclical purposes presents difficulties which I shall not attempt to review. But as cycles come and go trends continue, and Federal spending trends are upward. You know better than I the problems of reducing an expenditure program once it is underway. Every year, and 1966 now seems more likely to go down in history as an outstanding example than as

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[16] See Tax Foundation, Inc., "Controlling Federal Expenditures," New York, 1964, especially pp. 27–44.

[17] A lower level of corporation tax rates in general seems to me preferable to the differences in rates which grow out of the investment credit. But this is not a matter to be discussed at this point.

[18] Real costs as sacrificed alternatives are generally higher when the economy is operating at essentially full capacity than when Federal spending brings into use productive capacity which would otherwise be idle.

an exception, many major (nondefense) spending changes are under consideration. Under such circumstances the scope for choice about (*a*) adoption and (*b*) scale is not trifling. Nor is the increase in nondefense spending beyond control. New programs are being advocated. The administration supports expansion of others, and Congress has shown willingness to take the initiative in boosting outlays. For many programs the President has recommended continuation with little or no reduction when some contraction might be better than tax rate increases. The reductions included in the budget are encountering opposition.

For the near term we wish to reduce upward pressures on the price level. Federal buying (and transfers) account for part of such pressure. It can be reduced. Yet anyone proposing expenditure restraint must expect, and not unreasonably, the question, "Well, just what would you cut?" If he answers with "specifics," he seems to have assumed a heavy burden of proof, one involving details about a variety of matters greater than anyone's range of competence. Moreover, the supporters of the programs can "zero in" while the rest of the country occupies itself with more congenial activities than supporting the advocate of reduction.

The following points seem to me worthy of consideration now:

(1) Identify those types of Federal spending (indirect as well as direct, including credit programs) which raise costs and prices, not only "in general" but more especially on those things for which the money is being spent. Construction comes to mind at once. But there must be other cases in which the supply of the inputs is "tight" (relatively inelastic) so that more than a small fraction of the increase in outlay goes into higher unit costs. Perhaps special attention could be given to those cases in which private businesses—and philanthropies—suffer from the competition of Uncle Sam's "long purse." A concentrated effort to restrain (the growth of) spending in such cases would be in order.

(2) Delay can offer leeway for easing near-term pressure on the economy without abandoning undertakings. Postponement of some new construction, even if only a few months, would relieve immediate pressures, specific and general.[19]

(3) Decisions on some expenditure proposals in the budget were made several months ago. Conditions were not like those we face now. (Not so long ago we heard talk about "fiscal drag," with the implication that starting spending programs with an upward trend might be wise in helping forestall downward pressure on the economy in a year or two.) (*a*) The evaluation presumably assumed that no increase in tax rates would be required to pay for these projects. But if tax rate increases now seem necessary, the original justification for the spending can hardly stand in all cases. (*b*) The rise in market interest rates reflects a new evaluation of the present as compared with the future. Application of today's interest rates in the reappraisal of expected benefits from long-lived projects would show that on the basis of the criteria used to justify them originally some are not warranted at this time.[20]

(4) We now look to an even higher degree of prosperity than assumed in preparing the budget. The country should be able, therefore, to do a little more privately (and through State and local governments) to pay for what it wants without so much Federal action, now defended to varying degree on some form of redistributive argument.

General versus pinpointed tax changes

When tax rates are high, total tax collections are large, and the revenue structure complex, economists can suggest tax changes which, per dollar of revenue (or by some other unit of measurement), will exert relatively large influence of one or another specific type. If occasion for special action arises, some tax changes will seem to be better suited than others to the specific needs of the moment. Pinpointed actions, anything of narrow scope, may appear to be most efficient. Nevertheless, for reasons which space limits do not permit me to develop here, the presumption seems to me to be against special features as they

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[19] Construction projects involve commitments for future spending. This year's start ordinarily requires larger total outlays next year and beyond. A few months of delay in 1966 would increase our freedom to reexamine in the light of actual developments in the economy.

[20] A rise in benefits before discounting can, of course, offset a rise in the interest rate. A dollar payable in 30 years is worth 31 cents now if discounted at 4 percent, 23 and 17 cents with 5 and 6 percent discounting respectively.

would in fact, be incorporated in the law and as they would develop over the years.[21]

The need for the near future is for general restraint. And for general action, stimulus, or restraint, broad policies are to be preferred. Their effects will be most consistent with general efficiency in resource allocation.

A still more general goal appeals to me strongly: Every tax change should make the tax system more like that with which we should like to live indefinitely. Even changes made for emergency, and apparently temporary, purposes should be consistent with, and if possible an element of, a program of longrun tax reform. No blueprint for longrun tax reform can be expected from any deliberations now foreseeable. Yet as Congress and the executive face issues of tax change, explicit consideration might well be given to the question, "Which alternative will fit best into the plan for the tax system which we wish to pass on to our children?" My preferences are summarized in general terms in the article attached.

The Treasury, according to reports, favors "neutral" change if any action is required soon. I gather that by neutrality, the Treasury means equal percentage change in personal income tax liability at all income levels, plus approximately the same relative change in corporation tax rates.

The argument for neutrality is political rather than economic. If speed were highly important, sacrifice of the possibility of improving the tax structure might be worthwhile if doing so would reduce controversy and hasten action. The academician is hardly the one to suggest to Members of Congress the merits of different political strategies. But how urgent, really, is the need for speed? I claim no competence in shortrun forecasting. My hunch is that the outlook is not such that a few months more or less in enacting a tax law will make much difference. No great effort has apparently, yet been made to slow the rate of growth in the stock of money.[22] Delay in tax action might induce the monetary authorities to make fuller use of their powers, a policy I would prefer to near-term increase in tax rates. Moreover, delay in a decision on tax change might, or might not, add an indirect restraining force. Perhaps an early agreement to raise taxes would weaken any resolve to slow the increase in appropriations.

For shortrun needs, if they develop, an equal proportionate change in personal income tax liability would meet my criteria of desirable change reasonably well. Such action would not offset at very low income levels the effects of the erosion of the purchasing power of the personal exemption; the narrowness of brackets and the resulting steepness of progression would remain; the top bracket rates would be increased rather than reduced; special provisions which I dislike would continue, and no "improvements" would be added. Yet an imperfect world requires compromises.

Boosting the corporate rate, however, would get, not my endorsement, but condemnation. For reasons summarized in the article attached, I believe that progress in taxation requires reduction in the corporation rate. Even a "temporary" increase would work against the general welfare.

Tax Revision: Problems for the Long Run[1]

(By C. Lowell Harriss, economic consultant, Tax Foundation)

The poet who sang that man is the master of his own fate may have been a bit romantic. As individuals, and even as nations, we find ourselves subjected to forces beyond our control. Not all problems are solvable. Yet we do have power to influence our destiny, to deal more, rather than less, wisely in building the future in which we shall live.

Could there be a better example than taxation? The average American now pays taxes of nearly $900 a year—about $3,500 for a family of four. The per capita figure has gone up $150 in the last 5 years. And taxes do more than collect dollars. The nonrevenue effects of taxes produce effects of profound importance. To members of my generation I sometimes say, "Among the legacies we leave our children few will influence their lives more than the tax system." To university

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[21] World War II taxes on transportation lasted long after their usefulness had disappeared and actual damage to the economy had become about as clear as anything in Federal tax policy.

[22] Or has there been a change? The February figures are certainly consistent with a reversal of policy. Only as the weeks pass, however, can we be certain.

[1] Reprinted from Tax Foundation's Tax Review, February 1966.

students I say. "You are inheriting a tax system which will affect your lives at every turn; you also inherit a society which gives you the means of controlling taxation. Your best interest calls for determined, sustained, and informed effort to improve the tax system."

Fortunately, progress has been made. Federal taxes have been modified significantly three times in 3 years. There have been many more changes in State and local taxes. Not all changes deserve place in a list of examples of progress. Yet all changes do give proof that effort can bring results, that man has some control over this element of his fate.

The outlook includes contrasts. State and local governments as a group will face powerful pressure to spend more than can be paid for the normal growth of revenue from existing taxes (plus borrowing and funds from the Federal Government). If we want more and better quality services from State and local governments, how can we expect to escape increases in tax rates and in some cases the addition of new revenue sources?

The Federal outlook differs markedly. The Federal tax system has far greater growth potential as a revenue producer than most of us realized until recently. The personal income tax with a fixed (and relatively low) personal exemption and sharply progressive rates will take for the Treasury a considerable fraction of increases in our incomes. A 48-percent corporation tax will also demand more and more dollars as the economy grows. The average annual increase in Federal revenues may be \$6 to \$7 billion; i.e., in 3 years income tax revenues may be \$20 billion higher than at present if the economy prospers.

Reduction in Federal tax rates, or other revenue-reducing changes, will be possible.[2] They are much to be desired. No small part of our present tax structure is the product of emergencies long past—the great depression, World War II, Korean fighting. Action taken in emergency is not likely to be best for the long run. But what would be best?

Americans do not agree on explicitly formulated objectives of policy, goals to which to turn for clear guidance in choices on tax policy. Yet some goals seem so generally desirable that we can organize discussion of tax change around them.

Economic growth

Most income is created in business firms. Most economic growth will consist of what we do in the world of business. Businesses are the chief agencies for utilizing human and material resources to produce more of what we want. Success in progressing economically depends heavily upon the effectiveness and efficiency with which businesses operate. Man does not increase his chances of producing more efficiently and abundantly by taxing business heavily.

Taxes differ from other costs in a way significant for economic efficiency and progress. In saving on taxes, a company does not economize on the use of what taxes buy—Government services—in the same way that cutting wage or material costs will ordinarily require economizing in the use of labor and materials, real economies which are the basis of greater value to the consumer. And everyone is a consumer. Tax-induced wastes distort the allocation of productive capacity and retard growth.

State and local officials express concern about the effect of taxation on the economic expansion of the areas of their concern. Would it not be nice to impose taxes on business firms which would shift the burden to nonresidents, to force outsiders to pay for schools, highways, and other services? Rarely will such possibilities be large. Capital is mobile. Taxes which are high or otherwise onerous—in relation to the quality of governmental service benefiting those who are expected to pay—will lead businesses to flee from, or not enter or expand in, the taxing jurisdiction.

SMALL, NEW FIRMS SPEARHEAD GROWTH

The subject of tax incentives always presents difficulties. The rate of economic progress must be related closely to the individual's belief that he will benefit from actions which lead to economic growth. The desire for rewards; e.g., for one's family, has worked powerfully to speed economic progress. The

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[2] Cost of hostilities in Vietnam have pushed the date further into the future than seemed realistic when this paper was drafted in November 1965. The basic point retains its validity. C.L.H., February 1966.

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public acting freely in the market will offer rewards, often highly stimulating, to those who do something constructively for economic advance. Yet representatives of voters have used the power of coercion to nullify the results produced in the marketplace. High and steeply progressive tax rates must impair, as well as distort, incentives.

Economic growth depends heavily on the profit outlook. Profits actually obtained influence the expectation of profit in the future. They also help to pay for more investment. The spearheads of economic growth will often be small and new firms. As a rule they depend heavily upon internal financing. Government has little direct effect on the profit outlook of most businesses—except through taxes. Since the vast majority of companies are unincorporated, the results of their activities are subject to the personal income tax.

Economic progress requires venturing into the unknown—by large corporations, small businesses, individual investors, and workers. Losses are both frequent and large. Why does anyone freely put himself in a position where he may suffer a loss? Hope for profit offers one reason. Yet the more successful a person in risk taking, the more of his reward will be absorbed by the income tax. Losses, however, are not so fully shared by Government.

Economic growth requires capital accumulation to pay for additions to the stock of productive capacity, including housing. Moreover, the speed and thoroughness with which we utilize the fruits of advancing science and technology depend upon our ability to finance new capital goods. Dollar for dollar, some taxes fall more heavily than do others on the saving needed for capital accumulation. Per dollar of revenue, high-bracket personal income and death taxes tend to reduce savings substantially—and also the tax on corporation earnings.

High-tax rates create incentive to direct one's effort, skill, imagination, and talent toward reducing tax rather than toward more constructive activities. Society suffers but in ways few noneconomists understand. Economists, however, emphasize that growing specialization, refinement of the division of labor, are crucial for economic progress. They depend upon the broadening and improving of markets, upon the development of better opportunities for exchange based upon inherent economic merit. High-tax rates, however, obstruct the division of labor, hindering the process of exchange reflecting voluntary choice.

Income, sales, business, payroll, death, and other taxes are generally limited to market transactions. At points far below many present rates, taxes discourage the use of the market. One result is a hidden drag on economic progress.

To speed growth, Americans should plan for reducing the Federal tax rates on the corporations which produce so much of our output—to perhaps half the present 48 percent. A systematic, gradual reduction would get us near the objective in a few years. As corporation earning grows with an expanding economy, the increase can offset declining tax rates.[3] Benefits of rate reduction would spread throughout the economy—to consumers, employees, and those who supply capital.

Fairness and equity in the distribution of tax burdens

A dominating consideration in tax revision must be to make the system equitable. Unfortunately, one obstacle will not be removed soon—that of getting agreement on the meaning of "equity," "justice," and "fairness" as they apply to the sharing of the costs of government.

"Equal treatment of equals" we all endorse as a principle, but attempts to define "equal treatment" and "equals" reveal that consensus will not be reached soon. Still greater problems arise in trying to decide what is a fair basis for taxing one person more than another—and by how much.

HOW TO MAKE SYSTEM MORE EQUITABLE

Application of reasonable standards, however, seems to me to suggest certain changes to make the Federal tax system more equitable:

(1) With humanitarian considerations the guide, present burdens on the poor are often too high. Tax relief has not yet adequately reflected human need growing out of inflation; the burden of hidden taxes (those which are business costs, including taxes on earnings) remains high relative to a small income.

[3] The accelerated speedup of payments proposed in January 1966 seems to me better than a tax rate increase for meeting immediate needs. Sub specie aeternitatis, however, it must be evaluated on the basis of other criteria.

(2) The scale of graduation of rates seems to me steeper than can be justified on grounds of equity. Reform could accomplish much by broadening of brackets.

(3) The difference between the lowest and the highest income tax rates seems excessive. No one can prove that the results are inequitable or fair. Yet considerations other than fairness warrant respect. The top rate is five times the beginning rate. The highest rates do much to influence behavior—but yield very little revenue. Unless there is more than I know to be said in favor of very high rates as producing equitable results, reduction seems clearly indicated as part of longrun reform.

(4) People in essentially similar circumstances pay significantly different taxes. Loopholes exist. So do provisions which lead to excessive burdens in particular situations. Taxpayers have differing opportunity to take advantage of special provisions of the law. Many inequalities and inequities result.

Moderation of tax rates—especially the most extreme—seems the surest way to remove many inequalities and to mitigate others. The person now enjoying a loophole would not gain from a cut in a tax rate which does not in fact bear upon him. The benefits would go to those who now pay.

To raise the level of tax equity one essential is improvement in administration. The property tax presents especially great needs. Fortunately, experience shows that progress is possible—and the means to be used.

Fairness in sharing Government costs has another aspect—relation to the benefits from the spending paid for. If I were to ask, "Is it not fair to make the differences in the amounts we pay for government depend upon the benefits we received?"—many would reply "No"—so would I, but noting exceptions. One of these special cases deserves more attention than allowed by today's conventional wisdom. The services rendered by local governments differ in quantity and quality. Reliance upon local financing automatically requires the people in an area to pay for the benefits they receive. When costs of service are paid for by taxes collected on a State or the national level, however, the people of one area can be compelled to pay for services supplied to others.

The current fashion is to see merit in arrangements which impose taxes over a much broader area than can be identified in the supplying of services. Some arguments have merit—at least they will be found in my own writings. Yet are the results always equitable? I wonder. Results are rarely clear. In thinking about "justice in taxation" we should consider the extent to which people in one area are forced to pay for benefits elsewhere.

Competitive position in the world economy

To us as individuals, the country's adverse balance of international payments seems remote. Any such lack of awareness, however, does not mean that our lives can escape the ill effects. The outlook appears less than reassuring. Perhaps forces now operating will eliminate the problem. More likely, Americans will be forced to do more.

Tax policy can do a part. It may not be large, but the most promising direction seems to me to be reduction in taxes (a) which are business costs or (b) which curtail the attractiveness of investment in this country. Only Federal taxes offer much scope for action—to stop trying to make foreign consumers or investors pay for some of the cost of our Government. The corporation income tax and social security taxes are costs which American firms cannot escape, whether trying to sell abroad or to compete with foreign producers selling here (many of whom are relieved from domestic taxes on exports). Big increases in social security taxes already legislated work in the wrong direction as regards our competitive position in the world. But the case for reducing corporation tax rates gains force, not only because cuts in corporation tax rates would reduce prices on American goods—here and abroad—but also by enhancing the prospects of profitability from investment in this country.

Land value taxation: A new look at an old idea

Land prices have risen tremendously since World War II. As Americans and as people in lands from the developed to the near primitive, plan for the future, might they not try seriously to channel socially created values into public treasuries? Land rent or its equivalent often contains a true economic surplus. Though Henry George oversimplified, he had a point which deserves attention today.

The postwar rise in land prices includes increases which were not attributable to equivalent productive contribution by the owners. The equity of trying to reach past increments (beyond what a tax on capital gains will take) may strike most of us as dubious. But a future lies ahead. Population increase and the growth of capital may lead to future windfalls for landowners. If so, would it not be equitable and feasible to get more revenue for government, presumably local, from what is essentially an economic surplus created by society? A new look at the issues, using modern economic theory and the evidence available, might well be worth some effort.

Concluding comment

Time limits preclude discussion of many important issues. For example, simplification deserves attention—and action. The broad and basic issue of taxation as it impairs personal freedom, necessarily in some respects, needlessly in others, demands our deepest thought.

Perhaps the aspect of overriding importance is expenditure. The direct burdens of taxation will depend entirely, and the indirect burdens will depend largely, upon government spending. How can we develop the best procedures for making expenditure decisions? This challenge demands the best of our intelligence. Everyone can point to opportunities for doing good things by spending more money collected through taxes, virtually all of which must be paid for by the advocate's neighbors and others he has never seen. Yet how often can we say with reasonable assurance that the benefits will exceed the costs? How can we identify the cases in which public benefit will be greater than public harm? In the words of one of history's greatest economists, Alfred Marshall:

"Government is the most precious of human possessions, and no care can be too great to be spent on enabling it to do its work in the best way; a chief condition to that end is that it should not be set to work for which it is not specially qualified, under the conditions of time and place."

Representative GRIFFITHS. Thank you very much. Now may I ask each one of you to answer: In your judgment, is the economy sufficiently overheated now that the Federal Government should take some action? Mr. Brazer?

Mr. BRAZER. I would answer your question, Madam Chairman, by saying that it seems to me that the present position of the economy and, more important, the position toward which the economy appears to be moving, would justify the Federal Government taking counter-inflationary action now; yes.

Representative GRIFFITHS. Thank you. Mr. Brown?

Mr. BROWN. I would agree with Mr. Brazer. I think that more fiscal action is called for at the present time.

Representative GRIFFITHS. Thank you. Mr. Buchanan?

Mr. BUCHANAN. I think there is no question but what the economy was overheated from June through January. The Federal Government, if you include the Federal Reserve Board, has been taking action, apparently, since the first of February. The question comes as to whether or not this action is going to continue, and whether we should, in fact, expect all of the anti-inflationary action to be done by the Federal Reserve or supplement this with fiscal action. My position, as I stated in my remarks, is that surely at this time it is proper for the expenditure side to be trimmed, especially in the nondefense categories, as much as possible. Whether or not this should be supplemented by tax adjustments would depend, in part, on some prediction as to the continuation of the Federal Reserve policy, and I am not able to predict what this will be.

Representative GRIFFITHS. Thank you. Mr. Harriss?

Mr. HARRISS. I agree. The Federal Government includes, or should include, the Federal Reserve. In the last few weeks, there seems to have been a material change in Federal Reserve policy. How long will it continue? My guess is that monetary restriction can do enough to do the job at this time, certainly if growth of expenditures can be restrained. For the short run, I would be inclined to rely very largely on monetary policy. After all, we have had a rapid rise in the stock of money for some time.

Representative GRIFFITHS. Now may I ask you, Mr. Harriss, if we resort to a tax increase which falls only upon personal income, and not on corporations, is it not possible that the resulting increase in income of corporations would result in even higher wage demands to offset the tax increases?

Mr. HARRISS. Well, if consumer demand were reduced, I would not expect an exceptionally large increase—or anything more than a normal increase—in corporate profits.

Representative GRIFFITHS. But could it not be possible that consumer demand might be decreased in some areas, and still be maintained in others? That is, consumers would make a choice as to which items that they would purchase, and there would be some items that they might continue with, regardless of the increase in taxes? Is that not right?

For instance, it can hardly be anticipated that car purchases would fall off. And, if they did not, if the automotive companies showed continuous increased profits, isn't it true that you would have a greater wage demand?

Mr. HARRISS. Wage demands will certainly reflect the profitability of employer. I am not sure that I follow the causal relationship between the tax changes, but——

Representative GRIFFITHS. Well, I assume that if I suddenly had to pay out $200 more in taxes per year, and I were working for a company that all at once showed up with $1 billion more profit, I would be mighty happy to see to it that they paid out my tax bill.

Mr. HARRISS. I see. I misinterpreted your question. The possibility you suggest, Mrs. Griffiths, cannot be denied. So many of these hard problems come down to two or three points. The power of certain organized groups in society to insulate themselves from effective forces of competition, including some wage demands, and fixed foreign exchange rates. If we didn't have to deal with them, many of these problems would be handled with relative ease.

Representative GRIFFITHS. Now may I ask you, Mr. Buchanan; you object to the continuing of investment tax credit, because you say that this causes Washington to determine when a corporation can invest or not invest. In reality, isn't this exactly the thing that we are seeking? Are we not really trying, if we increase taxes, to say to people, "Don't buy now. You cannot buy now. You must give the money to the Government"?

And a corporation is especially gifted with insight into seeing the time to do the thing when it is most advantageous to them.

Mr. BUCHANAN. Let me answer that question in two parts. To clarify my own position about the investment credit, I would—if opportunity arises now to get rid of it permanently—then I would favor getting rid of it. What I would object to is using the investment credit as an off-and-on device, and the reason I object to it, the reason I want to get rid of it permanently, is that I don't like to see a tax structure utilized for discrimination among particular types of activity. You are quite correct in saying that we are talking now about the possibility of tax increases, tax decreases, with the idea of causing people to act in certain ways. But we are not discriminating amongst people, whereas the investment credit, in a sense, discriminates among particular corporations in the sense of those which have accelerated investment plans, and so forth. I think we should seek always in the tax structure to have rules and regulations as general as possible that apply across the board; and certainly, in preference to the investment tax credit, I think it would have been much better when that was introduced to have had a simple reduction in the corporate tax rate across the board.

Representative GRIFFITHS. Now do you have any opinion of how much it would slow down the economy right now if the investment tax credit were suspended?

Mr. BUCHANAN. No competent opinion at all. I suggest that Mr. Brazer might.

Representative GRIFFITHS. Does anyone have any theory on how much it would slow down the economy?

Mr. BRAZER. Well, back when I was in the Treasury, and we were much concerned about how much the investment credit would speed up the economy, there was considerable uncertainty—in my mind, at any rate—but assuming that the investment credit amounts to somewhere in the neighborhood of about $1½ billion or $1¾ billion a year, I should think that outright reduction to zero of the investment credit might cut business investment in plant and equipment by, oh, I should guess, $2 to $4 billion, in that range, which is a rather small percentage of the projected $60 billion for 1966.

Representative GRIFFITHS. Thank you.

Now, may I ask each of you, how much of a tax increase do you think we would have to have before we would start laying people off?

Mr. BRAZER. Before we would start laying people off?

Representative GRIFFITHS. Before it slowed demand to the point where you would start laying people off, where it would create some uncertainty in employment.

Mr. BRAZER. May I first amend my answer to your first question?

Representative GRIFFITHS. Yes.

Mr. BRAZER. You asked whether or not we thought that fiscal action is desirable now.

Representative GRIFFITHS. Or any action.

Mr. BRAZER. My answer was yes, but I would like to modify that by saying that I would strongly oppose action that would reduce expenditures, particularly expenditures on domestic programs in the Great Society sphere. If we could cut expenditures as a consequence of our solving the Vietnam problem, I would be all for it, but not otherwise.

My direct answer would be yes, I think we need a tax increase, but I would strongly oppose reducing expenditures. Now there is obviously concern about putting on the brakes too high. My initial guess would be that a $10 billion tax increase would be too much. The estimates for projections for aggregate demand for 1966, back in November, before we knew what the defense outlay was going to look like, ran around $710 billion, and there appeared to be a pretty good consensus around that number. My friends who are experts in this area tell me that the present outlook is for aggregate demand in the neighborhood of perhaps $730 billion, and I would say that that probably is something in the neighborhood of $10 billion too much, in terms of our ability to sustain full or nearly full employment without price increases.

Thus, I would think that the desired level of tax increase is about $5 or $6 billion, and anything substantially in excess of that would be too much, in the sense that it would probably lead to an increase in unemployment, or to phrase it in your terms, lead to our laying people off.

Representative GRIFFITHS. A $10 billion tax increase translates into $200 per taxpayer, annually.

Mr. BRAZER. Approximately, yes.

Representative GRIFFITHS. Let me delay the rest of the answers until Senator Proxmire has had a chance to ask some questions.

Senator Proxmire?

Senator PROXMIRE. Thank you, Madam Chairman.

I would like to direct my question to Mr. Brazer and Mr. Brown, because, as I understand it, you two gentlemen favor a tax increase now, and I understand Mr. Buchanan and Mr. Harriss do not.

Are you aware of these factors: No. 1, that under present plans of the Federal Government, as I understand it, obligational authority is at its peak, and it is expected to decrease next year. Spending will increase, but obligational authority, particularly with regard to Vietnam and our defense establishment, is not expected to increase. In the past, especially in the Korean war, prices fell when obligational authority fell, although spending increased.

No. 2, there has been a visible reaction to the tighter credit situation, inasmuch as a number of municipalities have canceled their bond issues, and apparently in most cases are going to cancel the construction. There have been other reactions on the part of others that are maybe less specific, but my mail, and other evidence that I get, seems to suggest that consumers and some businesses are reducing their activity below planned levels somewhat because of tighter credit.

No. 3, the labor supply seems to be holding up pretty well. We still have 3 million people unemployed. The Secretary of Labor and the Commissioner of Labor Statistics both testified that we are going to get a big increase in the labor supply, in the coming months, and that we seem to be doing a pretty good job upgrading skills and meeting specific labor shortages.

No. 4, we were getting a huge increase in the capacity of our plant and equipment to meet demand.

No. 5, the stock market has been going down steadily, relentlessly, and while that is not always the best index in the world, it seems to fit into some of these other things, and it has been pretty consistent.

No. 6, just yesterday the Wall Street Journal announced that inventory accumulation has not been substantial; that last month it leveled off. So there is not the hoarding attitude and the inflationary attitude that might have been expected before.

No. 7, there has been the leveling off of profits which suggests that perhaps the investment in plant and equipment which was anticipated a few weeks ago may be a little expensive. The estimates may be excessive. It may not be much above $60 billion.

Now, taking all this into consideration, would you feel that there is any real case for caution on the part of the Congress, and on the part of the administration—a little reluctance to move ahead with any kind of a tax increase now, recognizing the clouded crystal ball that we have always had and recognizing that any tax increase is likely to have an effect at least a few months from now, rather than immediately?

Mr. Brazer and Mr. Brown?

Mr. Brown. Well, if I can comment first. Obviously, whether or not we should have a tax increase is a question related to monetary policy. The fact that I might want to put more weight on fiscal policy does not mean that, if monetary policy were terribly tight, I would keep it terribly tight if I tightened fiscal policy. But I don't think that the tax——

Senator Proxmire. Let me just interrupt you to ask, then, are you saying that if we had a tax increase, we might have some easing of monetary policy?

Mr. Brown. Yes. These two things obviously are interrelated, and cannot be thought of independently. To the extent that we are inadequate with our fiscal action, we then have to employ a tighter monetary policy than might be desirable from other points of view.

On the other hand, if your policy is successful, you are always going to get letters from people telling you about the plans they have had to cancel. That is the essence of the action that you are taking, to get them to cancel some plans, because you are moving other expenditures in to fill the gap of the expenditures you are trying to cut back.

Another aspect of this problem is, I think, that the tax program just enacted is really not a deflationary tax program; that it manipulates receipts so that the administrative budget looks very good. Three billion dollars of the annual increase comes from the speedup of corporate collections, but I don't think this has a very substantial effect on corporate investment decisions. I don't think the withholding changes are going to have very much effect on consumer spending, because, again, this is a reshuffling through time, largely, so that is about all you are going to get.

Senator Proxmire. A reshuffling through time, but the weekly pay envelope will be smaller.

Mr. Brown. That is right, there may be some reshuffling through time.

Senator Proxmire. People will be inclined to spend less, just because they have less in their pocket.

Mr. Brown. That is right, but this is minor. Remember that the major increase in withholding receipts comes primarily from incomes with adjusted gross income over $10,000, and these are people that have assets and can borrow, if they choose to anticipate the larger refund or smaller tax payments they are going to have to make in the future. So that given the fact that we are low on the fiscal side at the present time, I would still say, "let's go ahead," and the order of magnitude is something I would say that Mr. Brazer has mentioned, $5 to $10 billion—and see what happens. This may mean some weakening of monetary tightness, too.

Senator PROXMIRE. Mr. Brazer?

Mr. BRAZER. Mr. Proxmire, I will try and comment on some of your points.

With respect to the reactions to tighter monetary policy, specifically in the State-local area, I would say that the fact that the tighter monetary policy, which has meant, among other things, an increase in interest rates on State and local bonds of about 25 basis points in the course of the last 5 or 6 months, suggests to me that on the basis of past experience, there is even more reason for wanting a tax increase than would otherwise be the case, because I should expect that there have been some postponements in the issue of State-local bonds, there will also be a substantial tendency to attempt to catch up. State and local government officials ordinarily develop some preconceived notions as to the proper or appropriate interest rate to pay, and when the interest rate goes up, they tend to back off; then when they notice that this is not as temporary an increase as they might have hoped, they usually go ahead anyway. If your schools are bursting at the seams, and if your sewer pipes badly need replacement, and so on, despite higher interest rates, you are likely to proceed with the capital outlays and with the borrowing.

The fact that obligational authority is at a peak, but as you note, expenditures are increasing, again suggests to me the appropriateness of a temporary tax increase, which could readily be, then, dropped as the taxes responded to induced growth, and we grow up to this new higher level of expenditures.

On the fact that the labor supply is holding up—unemployment of 3 million, out of a total civilian labor force of 75 million—of course, it is not evenly distributed, not evenly distributed geographically, not evenly distributed among skills, age groups, and so on, but tends to be fairly concentrated among some specific groups that are not readily moved in short periods of time into active participation in the work force.

The increase in plant capacity certainly is encouraging, but it only suggests to me that this may give us less reason for concern about a nonsustainable investment boom than we might otherwise have.

As for the stock market going down—well, the stock market went down very strongly, as you will recall, in the spring and early summer of 1962, when we were more or less at the very early stages of our expansion to the present happy position of the economy.

Senator PROXMIRE. That was the reaction to the President's clash with Big Steel, wasn't it? In part?

Mr. BRAZER. This was the most visible——

Senator PROXMIRE. Well, there was a very strong hostility for a few weeks, at least, between the business community and the administration, and that kind of a situation would also, it would seem to me, result in at least temporary decline.

Mr. BRAZER. That is right, but I cannot identify, as an economist, reasons for the reaction in the last few weeks in the stock market. I think one needs to be more of a psychologist, perhaps a mass psychiatrist, than an economist, to understand what goes on in the stock market.

Senator PROXMIRE. Well, to see it as an isolated development, I would agree, but putting it together with these other things, it perhaps would make more sense.

Mr. BRAZER. I would think that the drop in the stock market, just as in the case of the rise in interest rates, has led to the postponement of some new issues, and to the extent that this has a dampening effect on investment and investment plans, then, of course, it does reduce somewhat the immediate need for a tax increase.

Senator PROXMIRE. I was also thinking of the assessment of the stock market as the investor's assessment of future profits, and this kind of assessment seems to me, to the extent that it is logical and rational, might be an estimate of the wisdom of sustaining high investment, plant investment.

Mr. BRAZER. Well, we have observed an increase of close to 50 percent in before-tax corporate profits in the course of the last 4 years, and if what the market is saying now is that this rate of increase is unlikely to continue——

Senator PROXMIRE. But profits have now leveled off.

Mr. BRAZER. Yes; and I think it is reasonable to expect it to level off, but I don't think that either the reaction of the stock market or the apparent present behavior of corporate profits, which may only be in the nature of a pause rather than a long-term leveling off—I don't think either of these, in my opinion, at any rate, are of immediate and great importance in this decision. But I would emphasize again that while I have said that I think that a tax increase is desirable now, I think that it is most important that we get the dialog underway in those committees that have legislative responsibility for the tax increase. I think it is far more important to establish the ground rules for discretionary tax flexibility on the part of the Congress than it is to do anything else at this point, and I think that we ought not to waste a great deal of time now—I should not say "waste" but spend a great deal of time now—debating the question as to whether or not we need a tax increase now.

As a matter of fact, by the time Congress finished its hearings, it might well be appropriate to cut taxes. But the important thing is that we have the ground rules established and are in a position, then, to move in either direction.

Senator PROXMIRE. Well, I want to follow up on that. My time is up. I will come back to it.

Representative GRIFFITHS. May I ask that each of the rest of you, beginning with Mr. Brown, answer the question I asked. How much of a tax increase you think would be necessary before you would start laying off people?

Mr. BROWN. Well, I mentioned when I was answering Senator Proxmire that I thought the order of magnitude between $5 and $10 billion at the present time seemed realistic, and necessary. Again, this is coupled with the fact that I don't think we have taken very much fiscal action yet that is significant in depressing expenditures.

Representative GRIFFITHS. What would you think, Mr. Buchanan?

Mr. BUCHANAN. May I, before I answer that, comment on Senator Proxmire's question to Mr. Brazer and Mr. Brown?

Representative GRIFFITHS. Surely.

Mr. BUCHANAN. I think that we ought to try amongst the panelists here to indicate as wide a measure of agreement as is possible, and let me say this: If the institutions were such that we could in fact trade off for easier money, I would also favor a tax increase. If the institutions were such that we could say we will have easier credit, this is guaranteed, and therefore, we have a tax increase, I think there are strong arguments to be made for not putting the full burden of stabilization, in a period like this, one the monetary authority.

But my opposition to a tax increase is, I don't think we could get that trade off, given the institutions, and certainly the record of the Federal Reserve Board does not give us any grounds for thinking this.

I can see a possibility of moving in with a tax increase, and the Federal Reserve Board continuing to tighten up with the policy that they have followed, and on the basis of past experience, you have to assume they will probably make mistakes.

I did want to make that general comment.

Now, to get back to your question, Madam Chairman, the one that I recall you asked each of us to reply to, was what tax increase would be required in order for people to start laying off workers. Any tax increase, any tightening up of monetary policy, in an economy like this, any shift toward tightening up demand, will cause some more unemployment than it would otherwise. This is simply a question where your employment objective and your anti-inflation objectives, conflict with each other, and you have to somehow decide on what sort of trade off you want. There is no particular point. You cannot say, "Well, we can have $5 billion more taxes without more unemployment." Any tightening is going to cause less employment than otherwise, or more unemployment than otherwise, because we are in a situation now where these two things trade off against each other. Full employment, as full as possible, is a desirable objective, and a price level as stable as possible is a desirable objective, but in trying to achieve them both, we recognize you run into conflict, given our institutions, and this is a decision as to how we trade these objectives off. We would differ, different people will differ. I personally would place primary emphasis on trying to maintain stability in prices. Other people place more emphasis on the employment objective.

Representative GRIFFITHS. If you think this, can you say what percentage tax increase would result in a 1-percent decrease in employment?

Mr. BUCHANAN. Any answer I would give you would just be off the top of my head.

Representative GRIFFITHS. Well, as a matter of fact, I don't think that I can exactly demand an answer on any of it, because we are so involved also with drafting of men—with employment of men in the Armed Forces. This is certainly one of the things that is now resulting in the decrease in unemployment. A demand from various sources, not just from the private sector.

May I have your answer, Dr. Harriss?

Mr. HARRISS. I would agree with Professor Buchanan that any restraining force would tend to reduce employment, man-hours, and perhaps number of people on the job. So will other policies. And one reason that I think prevention of inflation deserves higher priorities in the scale of values than some people accord it is that I believe that wage rates will tend to rise more rapidly in an inflationary situation. They do not later, and higher wage rates mean less employment for any given dollar amount of aggregate demand.

Now to come back to the real spirit of your question, I would think that a tax increase that was as large as $5 billion would have an appreciable effect on employment, not huge, but more than minor.

Representative GRIFFITHS. No. Well, now, you are saying that as the wage rates go up, you will have less employment.

Mr. HARRISS. Well, any given dollar demand, dollar aggregate of demand will buy fewer man-hours, the higher the average wage rates.

Representative GRIFFITHS. But now, as a matter of fact, as the wage rates have gone up, the employment has gone up.

Mr. HARRISS. This has been possible, I would say, only because the stock of money and the velocity of turnover have grown, and rather rapidly, for several quarters.

Representative GRIFFITHS. And the demand has increased.

Mr. HARRISS. Yes. There must be something there to finance the demand. The demand appears in use of money.

Representative GRIFFITHS. Dr. Buchanan, did you originally advocate the tax reductions of the past few years? Were you for those tax reductions, or not?

Mr. BUCHANAN. I did not testify before any committee, but I was in favor of them; yes.

Representative GRIFFITHS. You were in favor of them? Are you in favor of tax reductions to stimulate the economy, and expenditure decreases to cut off inflation?

Mr. BUCHANAN. Is your question as to whether or not I am in favor of using fiscal policy generally?

Representative GRIFFITHS. Yes. Well, specifically, are you for tax decreases to stimulate the economy?

Mr. BUCHANAN. Under certain conditions, yes.

Representative GRIFFITHS. Yes. Then, in case it gets too stimulated, in place of using tax increases, are you for expenditure decreases? Is that right, or is it not right?

Mr. BUCHANAN. Under certain conditions, that is true.

Representative GRIFFITHS. And what decreases are you for now? What expenditure decreases?

Mr. BUCHANAN. Well, I think, in specific terms, I would have to get the budget and look at it, but certainly the areas of the so-called Great Society programs would be the areas in which there should be cuts. The argument on which these programs were originally based was because we were in a situation in which aggregate demand was not sufficiently high.

Representative GRIFFITHS. Well, wouldn't it be true, though, that these programs, or some of these programs, are absolutely essential? For instance, the antipollution programs, I would assume, are called Great Society programs, but any delay in the antipollution programs really endangers generations of people. Therefore, this would be a very difficult one to cut.

Mr. BUCHANAN. Yes, certainly; that is, it seems to me, a desirable program, but that program in terms of dollars of spending is not very large.

Representative GRIFFITHS. All right, but it could be. There are programs, the antipoverty program, the programs where you are trying to educate the children. The money spent there today is less money spent tomorrow in welfare, I would assume. Would you agree that this is true?

Mr. BUCHANAN. It may be.

Representative GRIFFITHS. So that would be a very difficult one to hit. So that, in reality, it becomes terribly difficult to say decrease taxes to stimulate the economy, and decrease expenditures to head off inflation.

Mr. BUCHANAN. Well, I think in a situation when the economy needs stimulating you can argue that you should both decrease taxes and increase expenditures. This is essentially what we did do.

Now, it seems to me that in a situation in which you need to tighten up fiscal policy, you decrease expenditures and increase taxes.

Representative GRIFFITHS. Well, are you now for increasing taxes?

Mr. BUCHANAN. No, not at the present time. In my earlier comment, I said that if, in fact, somebody could guarantee me that we could have an easier credit policy, I would take a tax increase in exchange for that. I think you can argue very strongly that the fiscal mechanism should take some of this burden. We should not put it all on the tight money. But I don't think the institutions are such that we can get that trade off.

Representative GRIFFITHS. Thank you. Senator Proxmire?

Senator PROXMIRE. In my last questioning, the point came up that by the time Congress gets around to acting on a tax increase it might be time for a tax reduction, and the argument was made that this is one of the reasons why we should have the rules of the game clear, so Congress can act very promptly and the administration can enact programs within the guidelines set down by Congress. This is really the crux of these hearings, it seems to me: whether or not economic forecasting is sufficiently exact, and whether or not the period within which, even with good work rules, Congress can act and the consequence can be felt in the economy sufficiently is precise and limited. So you would get the kind of economic reaction that we are seeking.

Now I would like to ask each of you gentlemen if you can give me an estimate of the period for which you think economic forecasts are reasonably accurate, on the basis of recent experience; and also whether or not you feel that a tax action, and what kind of tax action, would result in stimulating or result in dampening down inflation, within this limited period?

Mr. BRAZER. I would say, first, that certainly we need to do more in the development of quarterly forecasting models as against annual forecasting models.

Again, 4 or 5 years ago, in the Treasury Department, we established, or began to work on, a quarterly forecasting model; and, as of the time I left, in the summer of 1963, it was my impression that this forecasting—this quarterly forecasting model—was working pretty well. I think that what we need is an ability to forecast for one, two, three, four quarters in advance, rather than simply for the period of a year as a whole.

Now, as I see it, we have the capability to achieve such quarterly forecasts with sufficient accuracy to permit them to be very helpful in the decisionmaking process connected with discretionary tax flexibility.

The major difficulty, as I see it, arises from the economic forecaster's inability to name the date on which, for example, the U.S. Government might decide that Ho Chi Minh is not such a bad guy after all, or that it seems appropriate to negotiate with the Vietcong.

Now, if the administration's attitude on issues of that kind should change tomorrow, or perhaps I don't understand the administration's attitude—but if, as I understand it, they should change tomorrow, and this should lead within the course of the next 6 months to a $5 to $10 billion cut in defense expenditures, then certainly it is quite conceivable that what now appears to be a situation in which I think an excellent case can be made for a tax increase could turn out to be a situation in which no such tax increase were needed.

Senator PROXMIRE. You are saying, then, that, provided the policies in the Vietnam war remain about as they are planned, provided there is no sudden change, you think we can make adequate forecasts.

Mr. BRAZER. Yes.

Senator PROXMIRE. It seems to me that this proviso isn't perhaps as significant as it has been in past conflicts—the Korean war, and certainly World War II—because the impact of the Vietnam war, big as it is, and psychologically as important as it is, it is of relatively very modest economic consequence, in view of the size of our economy. We are only spending for a total defense establishment something like 7.6 percent of our gross national product compared with far more than that 8.5 or 8.6 during the last half of the past decade, in the 1950's when we were at peace. We may have a war psychology. We do not have a war economy.

Mr. BRAZER. But that 7.6-percent figure, Senator Proxmire, is approximately equal to the present level of business expenditures on plant and equipment.

Senator PROXMIRE. What I am talking about is the total defense establishment. And the Vietnam segment of that is a far smaller fraction, around 1 or 1½ percent, perhaps, and we certainly don't expect to phase out total defense spending entirely, no matter what happens.

At any rate, your answer is that the main uncertainty in the situation would be the Vietnam war; save that, you do have sufficient certainty that you feel we could predict three or four quarters in advance. Then you would follow up, I take it, by saying that there are taxes which we could raise, whose consequences on the economy would be felt with sufficient promptness.

Mr. BRAZER. It seems to me that it is quite possible for the administration to ask for a tax increase on May 1, and for that tax increase to be felt through an increase in withholding by sometime during the first 2 weeks of June, if the ground rules have already been agreed upon.

And I think that this would have not an immediate but a very short-term impact, and could be sufficiently substantial to be of considerable importance.

Senator PROXMIRE. Well, I won't detain you longer, but would you state what taxes you think those are? Would they be personal income taxes, investment credit, and so forth?

Mr. BRAZER. My first preference would be for the personal income tax. I think that Mrs. Griffiths raised a very relevant point in connection with the reaction of labor unions to a tax increase on individuals not accompanied by a tax increase on corporate profits. And while absent that point, I would favor a tax increase that affected only the individual income tax, I think that both the political factor and the possible repercussions on wage demands would demand also an increase in the corporate rate.

Senator PROXMIRE. Well, let me just at that point, and I know I have taken much too long on this question, but because it is so crucial, let me say that this would seem to rule out action on the investment credit. I have a letter from the Treasury Department, and I will quote it in part, "The overall weighted average time between contract and placement in use of productive equipment eligible for the investment credit is therefore estimated at between three quarters and a year. If some allowance is made for necessary advanced scheduling of equipment purchases to be installed as building construction is completed, the overall average leadtime may be somewhat longer."

Now, if our forecasts are reliable, primarily, within a year, it would seem to eliminate the investment credit because the impact of its repeal would not be felt until you very possibly needed a stimulus instead of a dampener.

Mr. BRAZER. Senator Proxmire, if the investment credit were allowed at the time that the orders were placed or the funds spent in the purchase of equipment, there might be a great deal more to be said for temporary variations in the investment credit, but one must keep in mind the fact that the investment credit is allowed at the time the equipment is placed in service.

Now I can imagine a situation in which we face inflationary pressures, equipment has been ordered, but firms say to their suppliers, "Don't deliver it," or "We will keep it in storage until the investment credit comes back." The only effect that could have would be to increase rather than reduce inflationary pressures, because it would mean keeping added capacity out of production.

This is one factor. You must also keep in mind the fact that the investment credit of 1962 is limited to 25 percent of a corporation's tax liability for that year, for the year in which the investment credit was earned, the year in which the equipment is put in service.

Now what this has meant is that over the course of the last 3 years alone, we have developed a large backlog of carryover of unused investment credit. If the firm earns an investment credit of $100,000, and its tax liability for that year is, say, $200,000, it only gets $50,000 this year. Then you have a $50,000 carry forward.

Now what this might mean is that you would be giving the firms that have this carryover the investment credit anyway, even though for new equipment put in place in the year, it was disallowed. So that your dropping of the investment credit could have only a limited effect on corporate tax liabilities in total. I don't have the precise figures on hand, but certainly by late 1966 or 1967, the carryovers would probably amount to at least 1 year's investment credit of around a billion and a half dollars, so that while we are thinking in terms of temporary changes, you might in fact get no change in corporate tax liabilities in any of these years, because of the operation of the carryover.

I think that if you could rewrite the investment tax credit law, and I would certainly favor eliminating this 25-percent limitation that was placed there only because of a revenue loss constraint that was thought important when the 1962 bill was under consideration. If you eliminated this, and if you provided the credit, if you had some device for providing credit at the time the orders were placed, as Professor Brown suggested, or when the money was spent, then the investment credit would be an instrument more amenable to temporary change.

Senator PROXMIRE. Mr. Brown?

Mr. BROWN. I am in agreement, I think, with the remarks Mr. Brazer made about forecasting, but I would add just one thought here, and that is that it seems to me one of the advantages of flexible tax policy is that you can reduce your reliance on forecasting. You don't have to look way ahead and make a steep change in taxes.

Senator PROXMIRE. I want to be sure I understand what your agreement means.

Do you feel that the forecasting is sufficiently accurate? These unfortunately have to be subjective estimates on your part, don't they, because we don't have a great deal of evidence of this.

The Council of Economic Advisers, probably as competent a group of economists as we have—certainly very competent—were way off in their estimate of the increase in the GNP for this past year. They were off 25 percent.

Mr. BROWN. Yes, but again, remember that the difficulty usually stems from the Government sector. Trying to forecast the change there, I think, is very difficult. What I am really saying is that, if you have flexible tax policy, you then don't have to peer into a crystal ball for a long time ahead. You can reverse yourself on a short-term basis, if your forecast is wrong. That, it seems to me, is one of the essential aspects of having a flexible tax program rather than the kind of inflexibility we have had in the past.

Senator PROXMIRE. That is all on the assumption that there is not so much lag in the tax economic results of your change in tax policies.

Mr. BROWN. Yes; I was going to focus on the particular point you raised about how fast consumers react, or other people react, to the changes in tax policy.

We don't know very much about the speed of response of investment decisions to the investment credit, so I would rather just set that aside, and say it seems to be longer than consumers' reaction. The planning period seems longer, but I think you could shorten it if you did make a switch in the investment credit. I have made studies of consumer behavior back to 1948—and my view is not just based on the 1964–65 experience. Just to give you some numbers that are reasonably accurate, let's say, that a $5-billion cut in personal income taxes would result ultimately in something like a $9-billion increase in consumer spending. Within two quarters from the cut you would have probably $5 to $7 billion of the $9 billion increase in consumer expenditures. That, I think, is a sufficiently quick response. Given the fact that the legislative lag should not be more than a month, we should be able to implement changes and notice their effects in the first quarter substantially, and, by the end two quarters, would have at least half to two-thirds of the ultimate effect exhibited. And that has held up for quite a long period of time, some 15 years.

Senator PROXMIRE. Any foreign experience with this?

Mr. BROWN. No. Well, they don't have the kinds of studies that we have here, because their data are less satisfactory. And they haven't used the personal income tax countercyclically to any significant degree.

Senator PROXMIRE. Would you like to comment, Dr. Buchanan?

Mr. BUCHANAN. Well, I would only say, I have very little faith in the ability to forecast. The reason is that here you are dealing with a whole set of expectations. Expectation is dependent on the activities that are taken in this monetary fiscal field. This is the reason I am strongly in favor of some sort of general overall fiscal policy, which would lay down some predictability. There is no predictability in what the Federal Reserve is going to do, and when we don't know that, we don't know what the economy is going to do.

Senator PROXMIRE. Let me interrupt, please.

You referred earlier to the fact that often the Fed has been wrong. That is, they have taken action that has the effect of contracting the economy at a time when we needed expansion, and vice versa. On the basis of this experience, it would seem to me, too, that relying on this kind of action on the fiscal side, on taxes would be worse. With the Fed you have a panel of seven members who can act with quite considerable speed; but with tax changes you have a Congress and the President who have to act. It would be much more difficult to get this kind of rapid-fire action on taxes than on the monetary policy, which as you have so often indicated, is inaccurate.

Mr. HARRISS. I would like to comment.

I claim no competence in short-run forecasting, but I do think that if Congress wants to get better information about what is going to happen, it should set up institutions to find out what the Federal Reserve is going to do, is doing, is trying to do, and planning to do.

Senator PROXMIRE. I'm sorry; would you repeat that, please?

Mr. HARRISS. Set up institutions to find out what the Federal Reserve is planning to do, or is doing, because Federal Reserve action can, it seems to me, upset the best of calculations; the best of forecasts. And my understanding is that you do not know now what the Board is trying to do.

Senator PROXMIRE. Well, there are at least a couple of us on this committee who would certainly concur with that. We have been calling for a greater coordination between the Fed and the administration.

Representative GRIFFITHS. I think I might point out that the chairman of the full committee has felt for some time that the Federal Reserve has seceded from the United States.

Senator Javits?

Senator JAVITS. Thank you, Madam Chairman. I am sorry I was out, but I had four committee meetings going at the same time.

But I would like to observe that I have a bill, and I think it is cosponsored by some members of the committee, seeking to do exactly what Professor Harriss suggests, to get mandatory coordination of monetary and fiscal policy.

Senator PROXMIRE. I have a similar bill.

Senator JAVITS. I am delighted, and I hope we can do something to get a mandatory requirement to tie the Federal Reserve System, as to information, into the rest of the Federal Establishment. I think we will get something done on it.

I would like to ask you four gentlemen these two questions, if I may. I will state them both.

One, do you believe that we ought to vest discretionary authority in the President to raise or lower taxes within certain limits? I personally don't want that, so I am not trying, you know, to trap you into some answer by stating my view, but I think we ought to have your view.

The second point is this: Do you feel that if we fail now—and I mean within, let us say, the next 60 days—to take action to restrain the inflationary trend along the lines of some modest tax increase—I am told that you gentlemen talked in terms of somewhere in the area of $6 billion, which in round figures means something like under 10 percent of the tax take—that we are in danger of (a) the inflation getting ahead of us, in a damaging way, or (b) an inflation-recession cycle which could then mature, let us say, in a year or so?

Mr. BRAZER. Senator Javits, in answer to your first question, my preference would be, first, to see whether or not discretionary tax flexibility remaining in the hands of the Congress can work or not. Until it has been demonstrated that it can't work; until it has been demonstrated that with the President having asked the Congress for a quick increase or decrease in taxes, it is merely a waste of breath, I would not favor vesting discretionary authority in the President.

I would favor vesting discretionary authority in the President only after it were shown that the Congress is so inflexible a body, so slow to react, that this was the only alternative. I don't see the parallel, as some of my colleagues do, between discretionary changes in tax rates and discretionary changes in reserve requirements or discount rates. I don't think these are of the same species. The Congress has jealously guarded its prerogatives in the raising or lowering of taxes, and I think that those prerogatives belong with Congress, unless there is no alternative.

I don't think there is any choice open to us as to action within the next 60 days. I am of the opinion that it would take at least 30 to 60 days before the Ways and Means Committee and the Senate Finance Committee and the two Houses of Congress could decide which taxes to raise—corporate, personal; and if corporate—investment credit or tax rates; if corporate rates, normal tax, surtax, or both. The question as to what form the change in corporate and personal income tax rates should take, and as to the choice among an increase relative to disposable income, an equal percentage increase across the board, or an equal percentage point increase across the board, must be answered.

All of these question are bound to be subject to, and I think probably should be subject to, fairly extensive debate. So I think that even if the President asked for action tomorrow, it would be likely to take some 2 to 4 months before you could reasonably except Congress to act.

And then are we in danger of inflation getting ahead of us, or developing inflation that would inevitably lead from an inflationary boom to a bust or recession?

I do not look for a runaway inflation in the course of the next 90 days. I think that prices are likely to continue to creep upward, but this suggests a continuation of our experience of the last 4 to 8 months, rather than the experience of the period following the late spring of 1950, or say the 8 or 12 months between April, May of 1950, and a year later.

I don't look for an increase at a rate of 8 to 10 percent a year in, say, the Consumer Price Index, but rather an increase at the rate of perhaps 2 to 3 percent a year, which after all is no larger than the rate of increase in consumer prices that we experienced in the recession of 1957–58.

Senator JAVITS. Thank you very much, Professor Brazer.

Mr. BROWN. Senator Javits, on the first point, I have never advocated ceding discretionary authority to the President over tax rates, even within limits, until the legislature—the Congress—had its chance to demonstrate that it was unable satisfactorily to provide flexible fiscal policy. I don't think they have had that chance, and until they have I would reserve judgment and follow the traditional procedures.

On the second point, we tend to say, I think, and in the past we have done this repeatedly in recessions and otherwise. "Look, we don't need to do anything now. Things are going to even out. It is not too bad ahead." Then in 6 months we will look back and say, "You know, we should have taken action about 6 months ago, and things would have been a lot better."

It is very easy to talk yourself into postponing action. I, myself, perhaps am an activist, and would rather go ahead, and then undo whatever wrong I do in the intervening periods. If we take too much fiscal action now, it's readily reversible. Therefore, I would want more tax revenues now.

Senator JAVITS. Thank you very much.

Professor Buchanan?

Mr. BUCHANAN. Senator Javits, on the first point, I expressed myself in my prepared statement as strongly as I could. Congress, I think, should be very jealous of these powers. There has been too much power taken over by the Executive anyway, so my position is crystal clear on your first point. I don't need to elaborate on that.

On the second point, let me say that had the expansionary—the combined fiscal-monetary—policy that went on from June through January continued, we would in fact be in danger of a very, very serious inflation. But as you know, since about February 1, the Federal Reserve Board has tightened up. They have put the screws on. Now, whether or not we are in danger of an inflation now, I think, strictly depends on what the Federal Reserve is going to do.

I can see possibilities of them continuing to keep the screws on, and our not having—and perhaps the stock market is predicting this, in a sense—perhaps not having an inflationary situation, but a year that would be characterized by a very tight monetary situation, which is always vulnerable to a crisis of various sorts.

As I have said previously, certainly it is time to reduce expenditures to the amount possible, but I do not favor—because I can't predict what the Fed will do—a tax increase at this time.

Senator JAVITS. Professor Harriss?

Mr. HARRISS. I would oppose granting discretionary power to the President. As I have told you over the last 2 years, I have felt that the administration generally has underestimated the prospect of an increase in the general price level as a result of the policies being pursued. There now seems to me to be a popular tendency—not in the administration—to exaggerate the magnitude of any prospective price-level increases. Any large cumulation of expansion in the next few months—cyclical snowballing—seems highly improbable.

However, in response to your question about a recession, I think there is no question that distortions do get developed. Prices and wage rates get "out of line;" various mistakes are made. And more, the longer an expansion continues. In the past these distortions have been associated with the depth and severity of later recessions.

I would hope that we could avoid such things now. Yet one must recognize the possibility that the longer an expansion continues, the greater the danger of the development of unsustainable conditions.

Senator JAVITS. Thank you, gentlemen. I appreciate it very much; and thank you, Madam Chairman.

Representative GRIFFITHS. I would like to point out to you that I think you can take small comfort from the fact that the tax bill, which has just passed the Congress, did so quickly. First it affected relatively few people, and there was public acceptance by those people. They did not raise any real objections to that tax. Therefore, before the Congress can act quickly, I think you have to have a pretty widespread public acceptance of a tax.

Secondly, I think it would be a vast improvement if the Senate floor would change their rules, because even our best-laid intentions in the Ways and Means Committee often come out as a different type of bill, as it goes through that floor. So, we have some problem there.

Finally, I might say that I think at the present time, you would have a better understanding of a tax increase than perhaps any other time. I think there came to be a real understanding of the tax decrease, and representing a district which originally opposed it, I think that they came to understand and appreciate it. So that if ever the tax structure is to be used as an inflationary weapon, now is the time for such action, it seems to me.

I believe Senator Proxmire has some other questions.

Senator JAVITS. Madam Chairman, may I agree with you that the public climate, I thoroughly agree, is such that a tax increase of a modest character would be accepted today as a contribution to the sacrifice which the Nation seems prepared to make in respect to Vietnam.

Senator PROXMIRE. I think that is a wonderful expression. That is the kind of a risk that a leading Republican would be willing for a Democratic Congress to take in the coming election. [Laughter.]

Senator JAVITS. In which I am not running. [Laughter.]

Senator PROXMIRE. You are not running. Oh, yes, but if we misjudge the temper of the electorate and they haven't had this sudden attack of altruism and are happy to have their taxes increased, you know who suffers.

Professor Buchanan, you wrote really a remarkable paper several years ago, and I have used it many times in this committee and on the floor, pointing out that one of the weaknesses of economic policy in a democracy was that monetary policy is likely to be used to restrain inflation. Fiscal policy is very seldom likely to be used for this purpose, because it is unpopular to increase taxes and unpopular to cut spending. As a result, you foresaw a situation in which democracies, not just the United States, but Britain and other countries—and I think what has happened has reflected the excellence of your judgment—are likely to follow a policy of reducing taxes to stimulate a lagging economy—that is always popular—but when inflation comes along, of increasing interest rates, tightening credit. The result would be lower taxes than needed, a bigger debt, and higher interest rates.

In the time since you have written that, do you see any reason to modify those views? You have modified them somewhat this morning, it seems to me, but I wonder if you feel the principle still holds, and we still face the very serious problem of overcoming the national popular opposition to tax increases for any purpose and the vague acceptance of interest increases.

Mr. BUCHANAN. Well, Senator Proxmire, I am very glad you brought that up. I almost mentioned that before. The paper you refer to, which I called "Easy Budgets and Tight Money," was written in specific reference to the situation in England, and the argument was that due to the political situation, you would expect when you had the need to restrict aggregate demand, you would expect reliance on the monetary mechanism, you would expect an increase in interest rates.

On the other hand, when the need was to expand aggregate demand, you would expect a reliance on the fiscal mechanism through expanded spending and reduced taxes, and as a result, you would get a sort of ratchet effect. That is, as you went through periods, you would find the interest rate continually rising.

I think the only thing I would say now is that was written in specific reference to the English situation in the 1950's; certainly the situation in this country fully confirms that. I did not originally write it in reference to this country, but it fully confirms that situation, where we have taken our policy toward expanding aggregate demand largely through the fiscal mechanism, although there is some question about the last 5 years, whether or not, as someone already has suggested here, we have had both easy money and easy budgets, especially money, especially from June through January.

But certainly, I would not modify that position substantially. I might also point out in that connection, if you will let me have 1 more minute, that is, of course, if you accept this as a plausible position, that we will react this way, by having tight monetary policy and an easy budget policy, if over the average, that tends to be our combination, because of our institutions, then we are doing precisely the wrong thing, insofar as generating growth in the economy. Economists in the mid-1950's and notably Professor Samuelson, as you may recall, were arguing at that time that really what we should have—the optimal mix—would have to be easy money and do our tightening through the budget, and that way, we could, in fact, expand investment and get a more rapid rate of growth.

I think due to the political institutions in part, we have got precisely the opposite, which is going to be the most damaging, so to speak, in terms of longrun rate of growth. I think that should be brought out.

Senator PROXMIRE. Do you see anything we can do about this? About the only thing that occurs to me are changes which would be extremely difficult to make, probably impossible for the time being at least, maybe always impossible, in the Federal Reserve Board makeup. It is always going to be unpopular to increase taxes and in view of what has happened latterly, overcome the resistance which I think was perhaps in some cases or in some senses a wholesome resistance to a tax cut. We cut taxes in 1964, a period of great prosperity. Frankly, I was against it. I voted against it; maybe I was wrong. In view of developments, it appears that I was.

But the more important thing is that once people feel that as long as you have any substantial degree of unemployment, you should reduce taxes, it is going to be a policy which it seems to me may lead us to an excess in this direction, and may have a most unfortunate effect, unless we can somehow change either institutions or change public understanding.

I suppose we can talk about it, and that is helpful.

Mr. BUCHANAN. I think that is helpful.

Senator PROXMIRE. Can you think of anything else we can do?

Mr. BUCHANAN. I am very pessimistic. I think the only longrun improvement that might be expected is in fact modifying the structure of our institutions. And especially modifying—I think we talked about it here, and there seems to be some agreement—we clearly need, it seems to me, to coordinate the monetary fiscal policy aspects of the whole problem.

I mean, that seems to be something, the more we can move in that direction, even if we move a step at a time, that is bound to be some improvement. And we might coordinate at some time for the wrong reasons. But we can at least move in that direction. It would be very helpful, and ultimately, the only solution to this, it seems to me, is to have what I like to call a fiscal monetary constitution, by which I don't mean the specific constitutional provisions, but some sort of set of rules that are in effect agreed on in advance, and therefore, are predicted.

Again, this may be talking in the professor's ivory tower, and I think it is, to some extent, but improvement seems to me lie in that direction, or otherwise, we are going to be faced with precisely the problems that you raised and problems which we have been talking about this morning.

Senator PROXMIRE. I liked your automatic monetary policy proposal, which I think was also made by the University of Chicago economist, Dr. Friedman. The idea that it would be automatic, as we try and estimate the long-term growth of the economy, and the need for money, and an increase in the money supply of 3 or 4 percent, depending on the long-term growth of the economy, would give you an automatic market restraint when you needed it and a stimulation when you needed it.

There are a lot of objections to that.

Mr. BROWN. Senator Proxmire, may I tender a small demurrer about the reading of our fiscal history?

I have read it pretty carefully myself, and my conclusion is just the reverse: that it is much easier to raise taxes—if you look at the situation historically in the postwar period—than it is to cut them.

Senator PROXMIRE. You see, my point is that there has been a change in public psychology in 1964, because of what happened. That puritan attitude toward budget unbalancing tax cuts was the attitude in my State, too—that it was wrong and almost immoral to cut taxes in 1964.

Well, it was worked out, it was well accepted. Now it is a very popular action to cut taxes anytime. In the future, I am wondering whether we are going to have the same puritan attitude toward taxes that we have had historically. I don't think we are. That is the problem.

I would just like to suggest, however, that there is another point on which we seem to disagree, and I would like to follow up the point Chairman Griffiths made.

I think we should be specific in indicating where we would cut the Great Society program. It is hard to find a place to cut the Great Society program as such; because, if you examine the antipoverty program, which is so typical of the Great Society, what is it? It is an educational program, by and large; a whole series of training programs of various age levels and so forth, and either immediately, or in the not too distant future, it provides for people who will be better skilled, better educated, more competent to meet our labor shortage, and to overcome inflation. This isn't a theory. It is a fact. This is what Mr. Wirtz stressed when he appeared before us.

I think maybe we can cut spending where Dr. Harriss suggested—construction areas, roadbuilding, and a few areas like this, which aren't really Great Society.

Mr. BUCHANAN. I think it is very difficult if you try to argue that this particular program should be cut and this program should be cut, for the very reasons that you and Chairman Griffiths mention. You could make a strong defense for any of these programs. I think, for this very reason, the type of cutting that has to be done, and makes a lot of sense, is just simply an across-the-board type operation.

Senator PROXMIRE. You mean a 10-percent cut, or something like that?

Mr. BUCHANAN. Yes, sir.

Senator PROXMIRE. Well, don't you just create a situation in which you limit your labor supply, if you make a 10-percent cut in manpower training, a 10-percent cut in the Job Corps program, a 10-percent cut in the community action programs, all of which are aimed at giving people a literacy and a competence, so they can enter the labor force?

Mr. BUCHANAN. Well, I am thinking now of some rule by which you could, in fact, enforce a budgetary cut. As I say—as you were saying—you can argue strongly in favor of particular continuations, even expansions of particular programs, but this is always the problem. This is always the problem. So, suppose you come up with a situation in which you determined that, well, we need for aggregate demand reasons—after all, a lot of these programs were put in for aggregate demand reasons.

I don't see quite why it doesn't work the opposite way—therefore, they should be reduced for aggregate demands; but suppose you agree that you need to cut certain ones for aggregate demand reasons? Then you get into problems if you start picking out this program or this program, for the very reasons you mentioned.

Senator PROXMIRE. Let me just interrupt and say isn't that a historical difference? The Roosevelt program was a leaf-raking program to some extent. Personally, I thought it was desirable and necessary under the circumstances, but it was a make-work program. The Great Society, on the other hand, is a program which is very largely designed to help people develop a skill and education, and ability, so they can take advantage of a prosperous private economy; so the economy can take advantage of them; so that, under present circumstances, it is not a matter of taking away the leaf-raking, make-work, WPA type of organization. It would be a matter of cutting down on training programs, some of which are relatively brief, yet increase our labor supply and our skilled labor supply pretty promptly.

Mr. BUCHANAN. Well, no doubt some of that is true, and I would have to look back at the argument; but take, for example, the Appalachian program, which is simply building highways up and down West Virginia.

Senator PROXMIRE. That was in roadbuilding.

Mr. BUCHANAN. This was, in fact, justified because of the unemployment rate in that area, as I recall, primarily. And other programs, surely, of the same nature.

Senator PROXMIRE. Well, that is a program I voted against. I just have one other question for you, and then a brief question for Dr. Harriss.

I am very concerned about your statement saying that it is absurd to expect to, and dishonest to pretend to, deal with inflation by exhortation, by reliance on so-called wage-price guidelines.

Now, wouldn't you agree that at least some of our big business pricing practices we just can't get at by monetary policy, or by fiscal policy? How can you get at the price behavior of the steel industry by a policy of tightening credit, when they don't have to go to the banks. You know, they don't have to go to bankers to borrow money. They have such a terrific cash flow that they have plenty of funds.

Furthermore, how can you get at it from any kind of fiscal policy, when, even if they are operating at 60 percent of capacity, or now when they are operating at 80 percent of capacity, they increase prices?

It seems to me that the leaders of these industries do have, however, a realistic respect for public opinion and for public relations, and for the great power the President has to call attention to the situation. Now, you also have that same attitude in big labor. A very sensitive awareness that when the President of the United States speaks there is an impact on their membership. If you can have the President suggesting wage guidelines, and price guidelines related to some system which is basically fair, don't you have an influence which tends to retard unjustified price increase, in a big share of American industry, recognizing that much of our industry is oligopolistic?

Mr. BUCHANAN. Well, within limits. I would accept what you say. I think the way to get at the first part of the problem, the way to deal with those concentrations of power in the economy, is to get at them directly, through your antitrust law, and we need something to deal with big labor on a similar basis.

Senator PROXMIRE. Professor Buchanan, it is a theory that many people support, but as you know perfectly well, you are not going to get votes in Congress to do it. You are not going to get the action by the administration. So, while it is a nice theory, we have to recognize the world as it is. We have these concentrations; we probably are going to have them in 1970 and 1980. What do we do about it?

Mr. BUCHANAN. I accept this as political fact, but I would still argue that we shouldn't delude ourselves into thinking that we control inflation by talking these people out of what is maybe to their own interest. After all, in terms of the economy, they are not overly important.

Senator PROXMIRE. But it worked. It worked in steel; it worked in autos; it worked in aluminum; it worked with copper. It has worked over and over again. Furthermore, there is the example this sets, and this gives a labor leader something to hang his hat on, instead of having to go ahead and compete with these other unions, saying, "Steel gets a 10-percent increase; why shouldn't we?"

Steel didn't get that increase; autos didn't get that increase; so that means that, in these other areas, they are helped by a national policy which makes it statesmanlike, as well as patriotic, to follow a policy that helps the public interest.

Mr. BUCHANAN. Well, again, and we seem to simply reach disagreement here, but I don't think the experience of other countries is very helpful in this respect. England has tried this.

Senator PROXMIRE. We have done the best job here, I agree.

Mr. BUCHANAN. And they haven't been very successful in income-wage policy, but my emphasis would be on the deluding ourselves into thinking we can do something about inflation this way, and in fact, another aspect of this that worries me even more—and call it my prejudices, call it what you will—is giving the President this sort of power.

Senator PROXMIRE. We don't give him anything. It is voluntary.

Mr. BUCHANAN. I am greatly disturbed at this morning's Washington Post story, which follows up something that Secretary Wirtz mentioned on "Meet the Press" about 4 weeks ago, in which now the President apparently is proposing to withhold contracts on New Jersey highway construction because the union in fact is going beyond the wage-price guidelines.

Now, to me, that seems an arbitrary invasion of new power that the President or the Executive is taking over that wouldn't have been dreamed of 6 years ago in this country.

Senator PROXMIRE. Well, it may be good business. It may be what a businessman would do, and what an intelligent department head in the Federal Government should do, too. If your price is excessive, we won't pay now, we will pay later, or we will buy somewhere else.

But let me just ask you if you can give me any good solid economic reason other than the effective use of guidelines, and the relatively good performance of our prices in the last 5 years. We have had a 5½-percent increase in the price level compared with a 9-percent increase in the price level between 1956 and 1960. In the earlier period we didn't have wage-price guidelines; now we do. I can't think of any other big element in the economy that has had a significant effect in holding down prices. Indeed, as you indicate, fiscal and monetary policy have been stimulated.

Wouldn't you concede that this is at least from a practical standpoint something to consider, or do we have to disregard wage-price guidelines in analyzing our excellent price behavior in the last 5 years when we have had diminishing unemployment, greater pressure on plant capacity? It would tend to make you expect a far greater rise in price activity.

Mr. BUCHANAN. Certainly, the experience of the last 5 years indicates that there was more slack in the economy than some of us had predicted. I admit that I would not have predicted that there was as much slack as there was, and looking back ex post, we now know in fact that mistakes were made, especially in 1959 and 1960, in paying too much attention and worrying too much about the possible price inflation, and not enough about the employment. I mean, those are facts, it seems to me. The economy was able to sustain a sustained increase in aggregate demand.

I don't think, at least I would not attribute very much of the relatively stable price structure from 1960 to 1965, I would attribute practically none of that to the wage-price guidelines. But the fact is that the real growth in the economy, the real potential for growing was there. A lot of the slack that was present was essentially due to deficient demand.

Senator PROXMIRE. Demand is a lot more deficient in the earlier period, and you had the higher increase in price.

Let me just ask Dr. Harriss this one question, and I apologize for taking so much of your time. I will be very brief.

You suggested that we cut spending by postponing construction, and I think you were the one who referred to the fact that interest rates are now higher, and therefore you could reappraise, perhaps, the cost-benefit ratio, or the discount factor used in computing it. This is a most helpful suggestion, I think. Could you indicate what areas of construction you think would be most amenable to at least a temporary postponement?

I know, for example, we had no new starts during the Korean situation. We had no public works construction in World War II, but now we are expanding this area, and I am wondering if you were referring to that, or thinking of some other area of construction?

Mr. HARRISS. I cannot be specific, as I should like to be. Much would depend upon the tightness of the labor situation in particular areas, and what is happening to construction costs.

As to the discount factor, it is clear that wherever a program is justified on cost-benefit analysis, future benefits should be re-examined. Other things, such a highway constructions——

Senator PROXMIRE. An awful lot of money, a terrific amount of labor, and a great deal of materials are involved there. This is a program that if cut back, would certainly have an immediate effect on the economy.

Mr. HARRISS. Well, for many it is just a matter of not increasing. But some cutbacks may also be desirable.

The difference between my position and that of Professor Buchanan—and we are not in conflict if I understand his position regarding the New Jersey contractors—is that I would make it clear that a new (temporary) rule is being followed everywhere. New construction outlays are being delayed where the upward trend in costs is marked, not just arbitrarily here or there, but broadly.

Senator PROXMIRE. Thank you very much.

Representative GRIFFITHS. Thank you.

I would like to ask you, Professor Buchanan, since you feel that Congress should cut back expenditures, why do you object to the President's proposed action in New Jersey?

Mr. BUCHANAN. I don't object. I would welcome this with open arms.

Representative GRIFFITHS. But you just said that you objected to the story that he was going to stop these expenditures in New Jersey because of the wage increases.

Mr. BUCHANAN. Well, I strongly object to an arbitrary cutting back of a particular expenditure on a particular contract because the particular labor union happens to secure or demand a wage increase that doesn't fit some sort of arbitrary guidelines.

Representative GRIFFITHS. But you would think it would be all right for us to cut them with a broad ax?

Mr. BUCHANAN. Exactly.

Representative GRIFFITHS. Well, I think that the President has the inherent power to stop all these expenditures, and if he chooses this opportunity to say to any particular group: "Your price is too high," I think he is certainly well within his rights.

I would like to thank all of you for coming here this morning, for appearing in this first hearing on the effect of the tax policies of the United States, and whether or not now is the time to increase or decrease the tax rates.

I thank each of you very much, and I would like to announce that tomorrow morning, this committee will meet in the Capitol in the Atomic Energy Public Hearing room, S-407, at 10 o'clock.

(Whereupon, at 12:35 p.m., a recess was taken until 10 a.m., Thursday, March 17, 1966.)

TAX CHANGES FOR SHORTRUN STABILIZATION

THURSDAY, MARCH 17, 1966

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 recess, in room S-407, the Capitol, Hon. Martha W. Griffiths (chairman of the subcommittee) presiding.

Present: Representatives Griffiths and Widnall; Senator Proxmire.

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

Representative GRIFFITHS. The committee will be in order.

I would like to express the appreciation of the Joint Economic Committee to each of you gentlemen for appearing here this morning and giving us the benefit of your views.

Will you begin, Mr. Gordon?

STATEMENT OF ROBERT AARON GORDON, PROFESSOR OF ECONOMICS, UNIVERSITY OF CALIFORNIA, BERKELEY

1. INTRODUCTION

Mr. GORDON. In this statement, I shall offer some comments on each of the following topics: (1) the general desirability of having a flexible fiscal policy that can operate with a minimum of delay either to accelerate or to retard the expansion in aggregate demand; (2) why it is not easy to develop such a flexible fiscal program for stabilization purposes; (3) the apparent need for fiscal tightening in the year ahead; and (4) what fiscal tools might be used now if it is believed that additional restraint is necessary.

2. THE NEED FOR A FLEXIBLE FISCAL POLICY

The growing acceptance of the so-called new economics represents in large part belated recognition of the fact that Federal fiscal policy is an effective way of influencing aggregate demand and the level of employment and output—at least in an upward direction. But the new economics is entirely symmetrical in this respect. Fiscal policy can and should play an important role in restraining aggregate demand when the latter shows signs of becoming excessive. In a particular case, we may argue about whether "excess demand" in fact does exist or threatens soon to develop, but the principle that fiscal policy should be used both to stimulate and to restrain total spending in order to achieve our aggregative goals [1] seems to be clear.

This principle is now fully accepted so far as certain built-in fiscal devices are concerned, which we are accustomed to referring to as the "automatic stabilizers." Thus we take it for granted that the corporate income tax and progressive personal income taxes will cause Government revenues to rise rapidly during business expansions, thereby tending to moderate the pace of the upswing, and conversely during downswings. Under the tutelage of the Council of Economic Advisers during the Kennedy and Johnson administrations, we have learned to keep a wary eye on this automatic fiscal restraint. If our tax rates are high enough, the fiscal stabilizers may be too effective. They may increase Government revenues so rapidly, as private spending rises, that the resulting "full-employment surplus," given the level of Government expenditures, makes it difficult in fact to achieve full employment. Recognition of this fact led to the succession of tax reductions that has brought about a substantial decrease in the "full-employment surplus," even with a steady rise in the full-employment level of output.

The tax reductions of the last several years indicate that we are prepared to use discretionary fiscal policy to stimulate growth and to get closer to full employment. But we have done so only discreetly and at irregular intervals, after much soul searching, and only after we had put up with excessive unemployment for too long a period. It remains to be seen whether we are prepared to develop a flexible fiscal program that will seek, more or less continuously, to offset and even to anticipate undesirable changes in private spending in either direction. The tax legislation which the Congress has just approved represents a very minor exception to the statement that we have not yet used fiscal policy to restrain excess demand except in times of war emergency (World War II and Korea). And it remains true that we have as yet done little to develop the machinery for a flexible fiscal policy. Flexibility in this context implies three things to me: (1) the ability to make moderately small, as well as large, changes, (2) the ability to make these changes as frequently as such action is judged to be necessary, and (3) the ability to act promptly in response to not only observed but also anticipated changes in whatever are our target variables.

A word on the relations between fiscal and monetary policy is in order at this point. It is a corollary of the new economics that monetary policy cannot do the stabilization job alone. It has long been recognized that monetary policy is likely to be relatively ineffective by itself in pulling us out of a recession or a prolonged period of excessive unemployment—although monetary ease is an essential precondition for the effective use of fiscal policy in such circumstances. It is being increasingly realized, also, that it is not wise to put exclusive reliance on monetary policy to control a situation of excess demand that threatens to get out of hand. Without the help of a restraining fiscal policy, beyond what is achieved through the automatic stabilizers, the degree of monetary restraint that is required, or that

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[1] These aggregate goals are usually taken to be full employment, rapid economic growth, and price stability, subject to a balance-of-payments constraint.

the monetary authorities believe is required, may be excessive. Monetary restraint works with a considerable and variable lag; many of its effects are indirect and to some degree unpredictable; and a policy tight enough to bring an inflationary boom under control may also precipitate a slump. There seems to be a growing concern in some circles that something like this may now be occurring in the United States.

3. DIFFICULTIES IN DEVELOPING A FLEXIBLE FISCAL POLICY

While it seems clear that we need more of a flexible fiscal policy than we now have, there are serious difficulties in the way of developing the needed flexibility.

When I speak of fiscal policy in this context, I am thinking primarily of the use of changes in tax revenues to stabilize aggregate demand. Since World War II, the emphasis in discussions of stabilizing fiscal policy has shifted strongly from reliance on offsetting changes in Government spending to primary reliance on offsetting changes in tax revenues. It has come to be recognized that, as a stabilizing device, expenditure policy can play only a limited role. In the short run, there is not much room for substantial changes in Government spending, although frequent reference is made to the desirability of a shelf of light public works that can be quickly started and, hopefully, as quickly stopped. My own view is that levels and types of public expenditures should be decided on grounds of broad social policy, given what the people are prepared to pay for on the average over the long pull. I do not think that, with possible minor exceptions, we should cut back on spending on important public services merely to restrain an undesired rise in aggregate demand. For stabilization purposes, we should rely primarily on appropriate changes in tax rates.

When we turn to devising a flexible tax policy, a number of troublesome issues arise. These can be discussed under three headings:

(1) Should a stabilizing tax policy, beyond what is embodied in the automatic stabilizers, be completely discretionary, or should some element of "formula flexibility" be introduced?

(2) What kinds of taxes should be changed to implement a stabilizing fiscal policy?

(3) What do we know about the effects on private spending of changes in various kinds of taxes, and what are the lags involved in achieving these effects?

Given the constitutional fact that the power to change taxes rests with the Congress, and given the further political and administrative fact that it ordinarily takes considerable time to get a tax bill enacted—I should think this would be particularly true of tax increases—there is a good deal to be said for some form of formula flexibility if we want to use fiscal policy for stabilization purposes. President Kennedy made proposals in this direction in his January 1962 Economic Report. Interestingly, he proposed using a formula—based on changes in the unemployment rate—in connection with a request for standby authority to initiate and accelerate public works expenditures. In the case of his request for standby authority to reduce taxes by up to 5 percentage points, subject to congressional veto, he suggested no formula. His proposal, in effect, involved the delegation by Congress to the President of limited authority to engage in discretionary fiscal policy for stabilization purposes, but subject to congressional veto.

President Kennedy did not get the authority he requested, and I assume that it is unlikely that Congress will soon delegate to the White House standby authority to change tax rates, whether governed by a formula or not. At the same time, the present system is not conducive to the development of a flexible fiscal policy. This leads me to offer a variant of a suggestion that has been made before.

In each year's Economic Report, the President might propose, on the basis of the Council's evaluation of current and prospective developments, that Congress pass standby legislation providing for certain types of tax changes, which could then be put into effect at any time during the year by joint resolution. The President's proposal might be first considered by the Joint Economic Committee and then passed on, with what the committee considered to be appropriate recommendations, to the usual committees in both Houses. If the standby legislation were enacted, the initiative in requesting the joint resolution to put it into effect would presumably usually come from the White House, but it might also come from a congressional committee. Some provision would have to be made for possible action when Congress is not in session.

Under this arrangement, the President could propose each year—or more often if he thought necessary—whatever modifications he thought desirable in the standby legislation currently on the books. The great virtue of this arrangement would be that Congress could get out of the way in advance the long hearings and debates regarding the effectiveness, equity, and plain politics of altering particular kinds of taxes. The standby authority adopted might or might not have some sort of formula built into it—specifying what kind of action in response to what kinds of stimuli.

The second problem I mentioned in connection with developing a flexible type of tax policy concerns the kinds of taxes that might be altered for stabilization purposes. All of the kinds of Federal taxes now in use are prospective candidates, and the relative emphasis placed on various of them can and should vary with the circumstances. There are, however, important reasons for relying particularly on the individual income tax. As one expert has put it, "The individual income tax is more easily adaptable to formula or discretionary changes in tax rates for countercyclical purposes than the corporate income tax or sales or excise taxes."[2] I shall have something more to say about this later.

Now I come to the magnitude and timing of the effects on private spending of various types of fiscal action. Our knowledge in this area is still very limited, but some information is beginning to accumulate. A widely cited paper by Arthur Okun of the Council of Economic Advisers suggests that, even excluding effects on investment, the 1964 cut in income taxes ultimately increased consumers' spending by nearly twice the amount of the tax cut, and about half this effect was felt within 9 months. If we include the further effects on the gross na-

[2] Richard Goode, "The Individual Income Tax" (Washington, The Brookings Institution, 1964), p. 307.

tional product through the stimulation of business investment, Okun estimates the tax-cut multiplier to have been 1.6 by the end of 1964, 2.5 by the middle of 1965, and 3.6 ultimately. While the estimates of the additional multiplier effect resulting from the induced rise in investment are open to some question, the estimate of the consumption multiplier seems to rest on solid ground and to be in line with the results obained by other investigators. Actually, Okun seems to be conservative, if anything, in his estimate of the consumption lag.

Another recent study suggests that last year's excise-tax reductions also had a substantial stimulating effect. In general, our knowledge of the effects of changes in the corporate income tax, particularly the effect on business investment, is sketchy. I might report that an as yet unpublished study by Robert Hall and Dale Jorgenson suggests that corporate tax policy is highly effective in changing the level and timing of investment expenditures. I might add that they found that the investment tax credit had been particularly effective in stimulating business investment.[3]

In short, while our knowledge is still on the sketchy side, we know enough to be able to say that fiscal policy can have, and has had in the past, significant effects on the level of aggregate demand. And further, once we get by the recognition and legislative lags, the further lags involved once action is taken are not, in general, unworkably long.

4. IS FISCAL TIGHTENING NEEDED NOW?

There is increasing concern over the inflationary dangers inherent in the current economic situation. There seems to be general agreement that the Council of Economic Advisers has underestimated the rise that is likely to take place this year in both gross national product and the price level. Increasingly, also, questions are being asked as to whether the boom in business investment may not be getting out of hand—a concern that has not been removed by the latest Commerce-SEC figures on planned plant and equipment expenditures for 1966. The national unemployment rate is now down to 3.7 percent, and the decline in unemployment during the last 9 months has been much faster than most of us thought was probable or even possible. While, like many others, I hold the view that our objective should be, through a combination of monetary-fiscal policy and appropriate manpower programs, to bring the overall unemployment rate down to about 3 percent, I also think that there are dangers in bringing it down too rapidly merely through the expansion of aggregate demand.

I am particularly concerned that we may be entering a stage of the business cycle in which forces making for instability will become steadily stronger—with moderate inflationary consequences at first and eventually a marked slackening off in the expansion and probably a rise in unemployment. The present rate of expansion in private investment is certainly not sustainable, and we are likely eventually to see—more probably in 1967 than this year—signs of emerging excess capacity in particular industries and other indications of imbalance in particular sectors. While it has not happened yet to any significant extent, this rapid an expansion as we approach full employment and

[3] It should be noted that they dealt only with annual data.

full capacity is likely to engender speculative buying, ordering further ahead, and overly optimistic expectations among a growing numbers of firms. These are the classic symptoms of "overheating" in the late stages of a cyclical boom—a malaise to which, we like to tell ourselves, the body economic is now immune. But I wonder.

I have already indicated why I think it is dangerous to rely exclusively on monetary restraint as the only type of discretionary policy available in a situation of this sort. In my view, the Federal Reserve authorities would be wise not to tighten the monetary screw further. Yet I suspect they will be strongly tempted to do so without some help from the fiscal side. I think that they should be given this help.

Another point is relevant here. Fiscal and monetary policy complement each other. If, in a situation like the present, we must run the risk of imposing restraint too strongly or too soon, I should prefer to risk fiscal action that might be too strong, with a correspondingly easier monetary policy, than fiscal action that is too weak, with a correspondingly more stringent monetary policy.

5. HOW MUCH AND WHAT KIND OF FISCAL RESTRAINT?

I have already expressed the view that we need to restrain the present rapid expansion in plant and equipment expenditures. My first proposal, therefore, is temporary suspension of the investment-tax credit. I see no reason why this tax concession cannot be withdrawn and later reinstated as an integral part of a stabilizing fiscal policy. In a different form, the Swedish Government has been using tax incentives to investment for a number of years as an integral part of its stabilizing fiscal policy.

I would favor prompt action on the investment tax credit. Beyond this, I suggest that the appropriate congressional committees and the administration cooperate in the preparation of a package of tax increases that would restrain demand to the extent thought to be necessary. Because the magnitude and timing of the effects are more predictable, I would place primary emphasis on increasing the personal income tax. I realize however, that as a practical matter it would probably be necessary to raise the corporate income tax also.

There is considerable controversy as to the form that an increase in personal income taxes should take if in fact there is to be an increase. There is, of course, no single correct answer to this question. There are some economic issues involved, both regarding administrative feasibility and, more important, the question of differential marginal propensities to consume at different income levels. Without stopping to defend the proposal, I suggest that the increase might be strictly proportional—a flat percentage increase to be added to the individual's tax bill that results from the application of existing rates. The same percentage increase would, of course, also be applied to the withholding rate. This proposal would naturally not be popular with those in the higher income brackets, who understandably favor having the fiscal restraint take the form of raising the whole tax schedule by some number of percentage points. I prefer my suggestion both on grounds of equity and because of its administrative simplicity.

I have indicated that the investment-tax credit should be withdrawn temporarily as soon as the necessary legislation can be drafted and passed. As for the rest of the package of fiscal restraint, the following procedure might be followed. Assuming the administration can be induced to go along, hearings might be held this spring on the size and contents of an appropriate package. Following my earlier suggestion, the tax increases might then be approved by Congress on a standby basis, the legislation not actually to go into effect until confirmed by joint resolution. While I am not altogether sure that this would work, and there may be technical difficulties in using the joint resolution for this purpose, the standby legislation might specify the taxes to be raised and a modest range within which each might be increased, the actual amounts of increase being filled in only when and if the joint resolution is actually introduced. If workable, this suggestion would provide further time to evaluate the evolving economic situation and, at the same time, get out of the way now the inevitable debate as to the appropriate form of fiscal restraint if such restraint is eventually judged to be necessary.

In my opinion, such additional restraint will be necessary.

Representative GRIFFITHS. Thank you very much, Mr. Gordon. Mr. Shoup?

STATEMENT OF CARL S. SHOUP, PROFESSOR OF ECONOMICS, COLUMBIA UNIVERSITY

Mr. SHOUP. Madam Chairman, countercycle tax policy requires prompt action. The existing legislative machinery for formulating and adopting changes in tax rates or exemptions may well prove quite adequate. It should be given a trial before alternatives are urged. But it can be supplemented by some advance planning, especially by the relevant congressional committees. The advance planning would attempt to achieve a consensus regarding the types of tax measure to be adopted at the various stages of the business cycle.

The aim of countercycle tax policy is to prevent an expansion from leading to a considerable rise in prices, and to prevent recessionary tendencies from generating appreciable unemployment. We should not expect that these aims will be achieved completely. Prices will probably still rise somewhat in booms, and unemployment will probably still develop to some extent when depressive influences become strong. But the degree of increase in prices, or unemployment, will be much smaller than if no countercycle tax policy had been adopted.

Decisions on countercycle tax policy will need to be taken at four different points of time during a complete cycle: (1) when a stable, full-employment economy turns into an inflationary one, a tax increase will be necessary; (2) when the threat of inflation has passed, but strong depressive forces are not yet in prospect, this particular tax increase can be repealed; (3) when a recession threatens, a further decrease in taxation will be needed; (4) when the depressive influences have passed, this particular tax decrease should be repealed.

The tax increases that are imposed when inflation threatens, and that are later repealed, need not be of the same type as the tax decreases that are made effective when recession threatens and that are later rescinded. That is to say, the tax measures involved in periods (1) and (2), up and down from inflation, need not be of precisely the same type as those that are employed in periods (3) and (4), toward and away from recession. I am inclined to think that they should not be the same, for reasons to be given presently. In any event, this issue needs discussion.

This four-step proposal assumes that there will exist in every cycle two periods when the long-term, permanent tax system alone is in force. These periods are: The second period, when the tax increases that were imposed to restrain inflation will have been repealed, while still further tax relief to forestall a depression is not yet necessary; and the fourth period, when the recessionary forces will have disappeared, while inflation does not yet threaten. This four-period analysis is, of course, an oversimplified view of the business cycle. Yet, even so, it may appear too complicated as a background for planning countercycle tax policy.

A still simpler view would be that the economy is always moving so rapidly up or down that we should envisage only two periods: One, the potentially inflationary period, when tax rates must be above their normal level, and the other the period of threatened recession, when tax rates must be below their normal level. The normal level of taxation would then be just a concept, a base of reference, never itself actually in existence.

I prefer to work with the opposite assumption; namely, that there will be periods when a normal level of taxation will be in force, one that is compatible with periods of stable prices and virtually full employment. This assumption at least has the advantage of sharpening the question: Should the same taxpayers be in the countercycle game at all times, or should some groups of taxpayers be excused or excluded from some phases of the game?

Let us consider first the phase of the cycle we now appear to be in, and the phase we may be entering; that is, consider an economy close to full employment, yet one in which consumer prices have not been rising much faster than their gradual upward creep over the long term, but also an economy in which business forecasters warn us that taxes may have to be increased before long if present trends continue. We consider what types of tax increases would be appropriate.

Whatever is done, the consumption spending of very low income households should not be decreased. These households have difficulties enough without being asked to help check inflation by lowering their already inadequate standard of living. It is the other households and the investment spenders who should be restrained. They, too, would be the ones to receive tax relief when the inflationary threat had passed; they would be restored to their normal level of taxation.

The two tax changes, considered together—the one to check inflation, the other to restore the normal level of taxation after the inflationary threat had passed—would be consistent, in the sense that they would affect the same body of taxpayers. They would not be neutral, since the reduction of consumption would designedly not be spread over every household.

Let us move now to the point in time when depression is threatening—or, indeed, when unemployment has already developed to a substantial degree. A reduction from the normal level of taxation is in order, so that consumption and investment spending will increase.

Now the low-income households can safely be brought into the countercycle game. Along with everyone else, their tax bill will be decreased through a decrease in tax rates until the depression is over and the normal level of taxation is resumed. Upon such resumption of a normal level of taxation, tax rates on low-income households go up, along with the tax rates on all other income groups.

Over a complete cycle of four periods, this pattern of tax changes is not neutral, but it is consistent, in the following sense. The taxes imposed when inflation threatens are the ones that are removed when the threat has disappeared. The taxes reduced when deflation threatens are the ones that are reintroduced when the threat has disappeared.

Consistency, not neutrality, should, in my opinion, be the goal. Neutrality is not desirable for the same reasons that we find undesirable a proportionate, flat-rate tax for normal economic conditions. Ability to pay with respect to the tax system constructed for normal conditions has its counterpart in ability to help stabilize the economy.

The low-income household has little relative ability to help stabilize the economy when inflation threatens. To ask such a household to reduce its consumption in order to aid in stabilizing the economy is to ask of it a very great sacrifice indeed. But the low-income household, of course, possesses great ability to help stabilize the economy when deflation threatens and tax relief, not a tax increase, is in question; such a household gains enormously, in reduction of sacrifice, from the tax reduction.

When deflation passes and the tax structure returns to normal, the consequent increase of tax, back to the normal level, will weigh heavily on the low-income family, to be sure; but this fact must be accepted if the stabilization plan is not to be converted into a substantial redistribution-of-income device. Some redistribution will occur, over the long run, as anti-inflationary tax changes temporarily curtail the disposable incomes of all but the low-income households, as booms recur.

The chief impact of the plan, however, will be on stabilization, not redistribution. Insofar as redistribution is a goal, it is better approached by changes in the fundamental structure of the tax system, the structure operative in a normal period.

I turn now to the question whether in the period of inflationary threat the increase in taxation should be designed to check consumption spending or investment spending. Both will be tending to increase, in money terms. If there is some reason to believe that stability in the future will be easier to achieve if only consumption, or only investment, is checked now, clearly the repressive effect should be laid wholly on the one or the other.

Lacking any conviction that this is so, I favor repressing both consumption and investment spending by the tax increases adopted to forestall or mitigate inflation. This goal of repressing both types of spending does not mean that we must tax both. A tax measure that reduces consumption spending will thereby indirectly, but very quickly, depress investment spending, through the accelerator and similar reactions.

Checking investment spending will also reduce consumption through the multiplier, but probably not as speedily as a check to consumption reduces investment spending. However that may be, the issue is seen to be not one of whether the tax shall be of a type that reduces only consumption or only investment; any tax that reduces the one will indirectly reduce the other.

The question instead comes down to this: Which type of tax, a tax on consumption (or on households generally), or a tax on investment, will act most quickly, and will have the least undesirable effects on growth and stability over the long run, without at the same time creating substantial inequity in distribution of the tax burden?

Investment spending can be taxed directly by reducing or suspending the investment credit. This counter cycle move is at first sight attractive; it attacks directly one of the spending streams that rises most rapidly in a boom. But there is an inherent conflict between the long-term goal of the investment credit, to promote modernization and growth, and the short-term goal of checking inflationary pressures, for the following reason.

To be most effective as a counterinflation tool, reduction or suspension of the investment credit should apply to all investment spending that occurs subsequent to the date the legislation is proposed, or enacted, including spending on projects already underway at that date. If reduction or suspension of the investment credit applies only to the projects contracted for after the date the legislation is proposed or enacted, many months will pass before the rate of investment spending falls appreciably below what it would have been without reduction or suspension of the credit.

Indeed, investment spending on projects already underway would be adhered to the more firmly, since newly planned projects would not obtain the credit. But reduction or suspension that applies to all investment spending after the announcement or enactment date, including that already contracted for, will weaken the incentive power of the credit on the next round, when investment spending is to be encouraged. Business firms will not know whether they will in fact obtain the credit until the project is completed.

Reduction or suspension of the investment credit would affect only those projects for property with a useful life of 4 years or more, and would exert its full effect only with respect to property with a useful life of 8 years or more. Construction outlays would not be affected, nor would inventory buildups.

Some experience with countercycle changes in tax measures resembling the investment credit is available from the United Kingdom. The United Kingdom changed its investment allowances, extra depreciation, and initial allowances, accelerated depreciation, up and down during the 1950's in an attempt to fit investment spending to current business conditions (a recent announcement indicates that these devices are to be replaced by cash subsidies). Dr. Richard M. Bird has studied the results of this policy. He finds evidence that increases in the investment allowances were effective to some degree, chiefly through the incentive aspects, not the effect on working capital, and only with a lag of some 9 months. Decreases in the investment allowances seem to have had little effect, if any.

Another way to attack investment spending directly is by increasing the tax on corporations. A marked increase in the rate of tax would be required in order to force a reduction in investment spending by reducing available funds. Even when money is tight, the cash leeway possessed by large corporations is enough, relative to the amount of drain that would be caused by an increase of a few points in the corporation income tax rate, to allow spending to go forward unchecked.

Moreover, a large part of investment spending is undertaken outside the corporate sector, notably in agriculture and housing; it could be attacked directly only through an increase in the personal income tax. All this is not to say that the corporate income tax rate should not be increased when inflation threatens. Such an increase may be demanded by considerations of tax equity. But we should not expect much in the way of immediate decline in investment spending.

The foregoing considerations suggest that the best countercycle fiscal device in the boom phase is an increase in the personal income tax on net taxable incomes above a certain level, say above $2,000 after all deductions and personal exemptions, accompanied by whatever increase in the corporation income tax rate is considered appropriate for equity.

The personal income tax increase could take the form of an inflation surtax, tentatively computed by every taxpayer, against which tentative tax a tax credit could be deducted, on the order of $300, to exempt the low-income households. The surtax should be built on some formula that seems reasonably equitable: perhaps, if the increase is not a very large one, an equal percentage increase of all bracket rates.

By that I mean that if the 20-percent rate went up to 22 percent, the 60-percent-bracket rate would go up to 66 percent, both being a 10-percent increase in rates.

Let me consider briefly certain other taxes. A temporary spending tax on households would exert a powerful check on consumer spending, because of its temporary nature. It would of course exert no direct pressure against investment spending by unincorporated enterprises. Over the long run of several cycles, the spending tax might prove much more effective than an increase in the personal income tax, if households became accustomed to the temporary nature of the income tax increase and adjusted their finances accordingly, to maintain their spending.

Many households, however, are in no position to practice such an adjustment. In any event, the added administrative and compliance difficulties posed by an entirely new tax like a spending tax make it advisable to see first what can be done with the income tax. If the new tax is supported on much wider grounds of fundamental tax reform, that is another matter.

Changes in the payroll tax would have a powerful effect on consumption spending. But the chief, perhaps the only reason, for the existence of the payroll taxes is their connection with the social security program. If these taxes were changed repeatedly for countercycle purposes, the amount that any one taxpayer, or his employer, would contribute toward his social security benefits would vary arbitrarily with the pattern of business cycles during his working life.

Moreover, tax increases in the employees' payroll taxes to check inflation would strike, among others, the low-income households that have little or no ability to help stabilize the economy. Short-term changes in the employers' payroll taxes would distribute the cost of anti-inflationary pressure arbitrarily within the business community, at least over the short term.

The estate tax is not suitable for countercycle variation, partly because its revenue is so small, partly because an individual's contribution to economic stability should not depend on an irrelevant event, the date of his death. The gift tax yield is far too small to warrant consideration in a stabilization program.

Obviously, there is much work ahead for the congressional committees in attempting to formulate the principles on which there can be based the temporary tax changes, up and down, that will be needed for countercycle purposes. This fact is not surprising, since it is only recently that the principle of countercycle taxation has gained general public acceptance. Now there emerge the equally absorbing issues of principle that must be settled before a choice can be made among alternative instruments for implementing that policy.

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

Mr. Harberger?

STATEMENT OF ARNOLD HARBERGER, PROFESSOR OF ECONOMICS, UNIVERSITY OF CHICAGO

Mr. HARBERGER. Madam Chairman, I would like to focus my remarks on a single topic, the value added tax, and on its desirability as an instrument to accomplish the source of short-term tax changes, to which these important hearings are addressed.

The value added tax is a general business tax on the difference between the value of a firm's sales during a period, and the costs of the materials it purchases. As such, it automatically avoids the pyramiding of tax liabilities at different stages of the productive process, a pyramiding which is the notorious defect of turnover-type taxes.

Although it is possible to levy value added taxes at different rates for different products and activities, I do not propose that this be done. Rather, the efforts should be made to place the tax in as broad a base as possible, and at a uniform rate.

Following this route, the tax would have a minimum distorting effect on the workings of the economy. That is to say, the tax would come close to being genuinely neutral, as among the different industries and activities in the economy.

Finally, the value added tax is eminently suited to the tasks of providing quick upward or downward changes in the total tax take of the Federal Government. It could easily be organized with payments on a quarterly basis, so that a change in the rate of tax legislated at any moment of time could become effective in less than 3 months.

To appreciate the merits of the value added tax as a way of meeting rapid and unforeseen changes in revenue requirements, we need only look into the history of tax legislation in the United States, and in other countries. By and large, I believe it is fair to characterize the development of tax policy and legislation as something of a patchwork quilt. A need arises for a quick expansion of revenue, and governments appear to seize upon whatever tax changes appear politically feasible at the time.

Thus, we had drastic rises in corporation tax rates, plus excess profits taxes in World War II, and we had these plus the so-called Korean war exercises during the Korean episode. As all of us know, these emergency measures appear to have great staying power once they get embedded in the tax structure.

It wasn't until recently, with the Revenue Act of 1964, that the United States really got around to undoing the bundle of emergency measures in the field of exercise taxation that were enacted some 15 years before. That was quite a long emergency.

I recognize, of course, that revenue needs may, for various reasons, remain high, even after an emergency as such has passed. But if they do, they should be met by a tax structure that withstands scrutiny as a permanent or semipermanent policy. They should not be met, as they were in the post-Korean period, by measures that were arbitrarily discriminatory among industries and activity, that arbitrarily distorted the pattern of resource allocation in the economy, and whose incidence was capricious in the sense that it depended upon the particular tastes of consumers, and hence violated the fundamental principles of horizontal equity.

I believe that the U.S. economy should have as a permanent part of its tax structure a general broad-based tax which is as neutral as possible from the point of view of resource allocation, which is essentially nondiscriminatory among industries, and which meets the canons of fairness from the standpoint of equity, and which above all has the attribute that its yield can be raised or lowered quickly in response to changing needs for fiscal revenues.

The value-added tax meets these requirements. In principle and in spirit, it is the tax which falls at an equal rate on some very broad aggregate of goods and services.

There are three main variants of the tax. Under the first variant, business firms pay tax on the difference between the value of their sales and the value of all purchases of materials, semifinished products, and finally investment goods. In this form, the tax amounts to an equal rate levied on all consumer expenditures for final goods and services. As a consequence, this variant is sometimes called a value-added tax of a consumption type.

Under the second variant, business firms deduct from the value of their sales the purchases of materials and semifinished products, but not their investment expenditures. Instead of deducting investment expenditures directly as they are made, firms under this variant do deduct the normal allowance for depreciation on their existing capital.

When all the tax payments that would be made under this variant are added up over the whole economy, they amount to an equal rate tax on the entire national income. This variant is therefore sometimes called a value-added tax of the income type.

Under the third variant, business firms simply deduct materials and semifinished product purchases from the value of their sales. There is no deduction, either for investment or for depreciation of existing capital. When added up over the whole economy, the taxes in this case amount to an equal rate tax on the entire GNP, and the third variant can therefore be called a value added tax of the GNP type.

As among the three variants, I believe that either the first or the third should be preferred, solely on grounds of administrative simplicity. The reason for this preference is that neither of these variants requires any depreciation accounting. The first variant, the consumption-type tax, avoids depreciation accounting by making investment expenditures deductible, along with materials, purchases, as those investment outlays are made.

The third variant eliminates a depreciation accounting by simply allowing deductions only for materials and semifinished products purchased for further elaboration. It has the advantage of being the broadest base of the three taxes, the one which can produce the highest yield at the lowest rate of tax.

Obviously, the value-added tax entails some administrative problems, but these are not insuperable. The State of Michigan has had such a tax since 1953, and France has had one since 1954. The common market countries in Europe are now in the process of converting their indirect tax systems into systems of the value added type.

Broadly speaking, the administrative problems concern recordkeeping by the taxpayer. In order to deduct the purchase of materials from its final sales, a business firm should be able to produce a record showing the tax had already been paid on those materials at an earlier stage of production. This entails developing a system of invoicing and accounting by which business firms keep records of their sales to and purchases from individual firms, identified according to some taxpayer numbers.

This is not at all difficult for large firms to do, but it may place some burdens on smaller firms. However, certain groups of firms, like farmers, for example, could be relieved of this burden of recordkeeping, simply by having the tax on food products paid either by the wholesaler or by the processor. That is, wholesalers and processors would, in effect, act as agents for the farmer, and would pay the tax on his behalf.

Farmers would not have the advantage of deducting material purchases, but since these are small in any event, it would be a small price to pay to be relieved of the recordkeeping burden.

Sellers of services which are basically bought by the final consumer, like doctors, lawyers, plumbers, and so on, would, of course, have to pay the tax and keep corresponding records as these taxes could not be collected at a later stage. Perhaps some groups in this category, I would say most particularly domestic servants, could be exempted from the tax entirely, as their exemption would mean a substantial saving in administrative expense, and only a small reduction in the generality or neutrality of the tax.

I must point out, however, that the recordkeeping involved in the value-added tax is not wholly a negative item. It is, in fact, a strong support for the personal and corporate income taxes, as the expenses claimed by business firms could now be checked in much greater detail than is presently the case. In brief, the income tax declaration of firm No. 1, claiming a purchase of a thousand dollars of materials from firm No. 2, could be checked against the declaration of firm No. 2, to make sure that that firm had in fact declared the same sale as a component of its income.

Once a tax of a value-added type is in the system, changes in rates are easy to accomplish. Congress could pass at any time a law raising the rate of such a tax from, say, 2 to 2½ percent, effective in the forthcoming quarter. This change in rates would require no alteration in tax forms; it would simply entail calculating the value added just as before, and multiplying the result by a different number.

Moreover, rises and falls in the value-added tax would very likely be the subjects of much less congressional debate than would tax changes of other types. Other types of tax changes tend by their nature to be non-neutral and to favor certain groups. It is clear that in such cases, political considerations guiding the different groups of legislators will differ. Each group will try to enact that type of tax reduction which most helps its interests, or that type of tax increase which least hurts it. No one wants to have his constituents come out with the worst end of the deal. A value-added tax avoids this, simply by being so broad based and neutral that it can genuinely be regarded as a tax on everybody.

I therefore submit the value-added tax for your most serious consideration, as a powerful and flexible instrument of fiscal policy, capable of providing short-term variations in tax yield, either in an upward or downward direction, with a minimum of distortion to the economy, without resort to taxes with capricious effects in terms of equity, and with the characteristics necessary for quick implementation of changes at both the legislative and administrative levels.

Thank you, Madam Chairman.

Representative GRIFFITHS. Thank you, Mr. Harberger.

Mr. Wallich?

Mr. WALLICH. Thank you, Madam Chairman.

STATEMENT OF HENRY C. WALLICH, PROFESSOR OF ECONOMICS, YALE UNIVERSITY

FLEXIBLE TAX CHANGES FOR ECONOMIC STABILIZATION

Mr. WALLICH. On the need for tax flexibility as an instrument of stabilization policy, a wide range of professional and public opinion seems to agree. Economists have called for this device for many years. The Commission on Money and Credit (CMC) recommended limited presidential powers to that effect. President Kennedy, in his Economic Report of January 1962, endorsed the proposal. Many have also suggested that Congress "streamline" its procedures for tax changes, as an alternative to delegation of powers to the President.

The experience of the 1964 tax cut has confirmed the economic analysis underlying these proposals. A reduction in personal income tax rates leads, with some lag, to a proportionate increase in consumption expenditures. Anticipation of the tax cut may exert an advance stimulus on business spending. A tax increase may be expected to operate similarly in the opposite direction. Still untested, to be sure, is the question of how effective a tax change will be when it is known to be temporary.

Part of the case for tax maneuverability rests on the belief that changes in public expenditures cannot be made with sufficient speed to become quickly effective. When economic fluctuations are brief, the cyclical impact of expenditure measures may even become perverse.

It is well to remember, however, that this alternative route is available.

Assuming general agreement on the desirability of quick tax changes in the face of inflation or recession, three areas need to be examined: (1) What is the best type of tax change? (2) what limitations and qualification should be imposed in advance to reduce the danger of bad judgment, inappropriate use, undesirable repercussions? (3) by what agency is the tax change to be instituted?

1. What type of tax change?

Every inflation, and every recession, is different. The principal source of instability of demand may be in the private sector or the public; it may be in the area of investment or consumption, or in the balance of payments; inflation may have an admixture of cost-push elements, or it may be associated with shifts in demand from one sector to another, and supply rigidities may play a role. From this unpredictable diversity of conditions, it is quite possible to draw the conclusion that advance planning for tax changes is impossible. Each special set of conditions demands a special tax change. Investment inflations or recessions call for tax action on corporations and in the upper personel income brackets. When consumption is deficient or excessive, tax changes in the lower income brackets are appropriate. When particular sectors, such as durable consumer goods or housing, are out of balance, special action there may be the best remedy.

It would be very difficult to develop rules that would distinguish and provide in advance for each of these and other cases. I would not preclude that at some future time our economic knowledge and our political organization might make this possible. That time, however, is not yet.

It would be a great mistake, however, in my judgment, to conclude that advance planning is impossible for these reasons. For, while we know that there are differences among inflations and recessions, we do not know how important these differences are as regards the best method of cure. We do not know exactly what would be the optimum remedy for each type of instability. We do know that any type of general tax change will have an effect in the right direction. Anything that affects aggregate demand affects all sectors of the private economy. Tax changes that affect investment thereby also affect consumption, and vice versa. In a flexible economy, changing the pressure at one point changes it everywhere. While our economy lacks that perfect flexibility, and in particular does not react instantaneously, I believe it would respond adequately to very general stimuli.

(*a*) *Excises and social security taxes.*—The question therefore becomes what stimuli work best and fastest while causing minimum disturbance. Excise and social security taxes seem poor candidates. Excise tax changes, as has often been noted, give rise to anticipation effects that are perverse. An anticipated excise tax cut, designed to stimulate demand, causes postponement of purchases; an anticipated increase has the opposite undesirable effect. Social security tax changes would interfere with the actuarial basis of the system. Both types of taxes would affect prices with possible undesirable repercussions.

(*b*) *Personal and corporate income taxes.*—As between personal and corporate income taxes, speed of reaction and minimum disturbance both seem to favor the personal income tax. Studies by Profs. Albert Ando and Carey Brown of Massachusetts Institute of Technology, as well as a recent study by Dr. Arthur Okun of the Council of Economic Advisers, seem to show that a fair share of the total effect on consumer spending occurs within the first quarter following the tax change. Most of the rest occurs within 1 year. The effect of changes in the corporate income tax, while large, nevertheless appears to be distributed over a longer period. Business investment projects, like public works, often have long lead and execution times, and cannot quickly be turned on and off. Corporate tax changes, moreover, may interfere with the orderly planning of investment projects.

The corporate income tax, nevertheless, ought not to be written off as a candidate for flexible maneuvering. Economic instability often has its roots in business investment. The objections of long lags and disturbance to business planning also apply to monetary policy that changes the cost of borrowed funds. Yet most observers would not reject monetary policy on these grounds. The possibility of operating through devices like the investment credit or accelerated depreciation, for instance, lends added attraction to making corporate taxes flexible. Dollar for dollar, these devices probably influence expenditures more than changes in tax rates.

(*c*) *New taxes.*—The possibility of introducing new taxes for the special purpose of flexible maneuvering must also be considered. This would be a long-range project. Major tax changes probably would not be adopted for this reason alone if they were not also desirable on other grounds. Among such new taxes have been mentioned a value-added tax, or possibly a Federal sales tax. I believe that a value-added tax would have much to commend it if it were substituted for part or all of the corporate income tax, including the possibility of rebates on exports. I see no special advantages, however, for purposes of flexibility. Variations in it as well as in a Federal sales tax would have perverse anticipations effects. They would also destabilize prices.

If the investment tax credit turns out to be a particularly good candidate for variability, an enlargement of the normal credit might be considered to give variations more leverage. Several foreign countries have experimented with similar devices—among them, I believe, Holland, Sweden, and Canada. I regret that I have not had time to examine their experience. A more detailed study would be worth while.

A technical difficulty connected with a flexible investment tax credit may additionally be noted. Many investment projects are not only planned a long time ahead, but also contracted for. Where firm contracts have been entered into, changes in plans are no longer possible. Yet disallowance of the credit can create hardship at the time the equipment is put in place, at which time the credit should become available. An effort to avoid hardship would require exemption from the suspension for equipment already contracted for at the time the suspension is enacted, perhaps with some time limit, as proposed in Senator Gore's bill. This, however, would greatly lengthen the lag in the full economic effectiveness of the measure.

Variations in depreciation allowances strike me as a less promising possibility. Depreciation practices are deeply embedded in business accounting systems. Frequent changes would probably cause a great deal of disturbance. It deserves to be remembered, however, that business resistance to any change in these areas has been strong mainly at the beginning. In the course of time business usually has found it quite possible to adapt itself and take advantage of whatever opportunities were offered.

(*d*) *Inventory taxation.*—Tax action to stabilize inventories is a device that I would like to commend to the attention of this committee. Inventory changes are one of the chief sources of cyclical instability. Swings from plus $10 billion to minus $10 billion have occurred in the past, for a net change of $20 billion. Inventory investment is not eligible for the investment tax credit, and it is hard to visualize a justification for making it eligible. A special tax on inventory increases in time of inflation might be considered, however.

Like all taxes, this one would involve technical difficulties. For instance, inventory accumulation would have to be measured relative to sales, not in absolute terms, since sales largely determine the need for inventories. Price changes would pose a problem, since higher prices may raise the value of inventories without change in physical volume, depending on accounting techniques. Nevertheless, as one of the main sources of cyclical instability, inventory fluctuations deserve to be examined from the tax point of view.

Greater longrun stability of inventories could also be promoted by taxes. A permanent tax credit might be offered to enterprises that maintain a high degree of inventory stability. The merit rating under the unemployment insurance contributions is an example of this approach. Special standards of stability would be required for different industries, since in some industries, such as supermarkets, inventories are normally stable, while in many lines of manufacturing they are not.

With these observations on new types of taxes, I hope to have responded in some measure to the request to give attention to possibilities in this area. After surveying them in very summary fashion, I return to the earlier conclusion that the personal income tax offers best prospects for tax changes that are effective, quick acting, and likely to cause minimum disturbance. The investment tax credit deserves consideration as a second line of defense.

(*e*) *What kind of income tax changes?*—That stabilizing tax changes should be "neutral" in some sense seems by now widely agreed. They should not, in other words, mix stabilization with reform. The changes should also be equitable. On the meaning of equity, however, there is no agreement. Fortunately, when we consider two-way changes, the equity effects wash out. A tax change that some might regard as inequitable for the upper or lower income brackets when the move is up has the reverse effect when the move is down.

Three particularly simple systems, among many conceivable ones, may be singled out:

(1) Equal percentage changes in the final tax liability in all brackets. This would be equivalent to a flat percentage surcharge on the tax that the taxpayer computes on Form 1040.

(2) Equal percentage changes in disposable (after tax) income in all brackets. This would involve computing the difference between taxable income and tax and deducting a flat percentage from this amount.

(3) Equal percentage changes in taxable (pretax) income. This would be equivalent to changing the tax rate in each bracket by the same number of percentage points.

TABLE I

Equivalent tax changes

(Illustrative assumption: effective rate equals 20 percent of taxable income, hence 10 percent of tax load equals 2.5 percent of disposable income equals 2 percent of taxable income.)

	Present rate	Increase/decrease as percent of taxes paid	Increase/decrease as percent of disposable income	Increase/decrease as percent of taxable income
Tax change equals 10 percent of tax load:				
Top bracket	70	10	23.5	7
Lowest	14	10	1.6	1.4
Tax change equals 2.5 percent of disposable income:				
Top bracket	70	1.07	2.5	.75
Lowest	14	15.4	2.5	2.15
Tax change equals 2 percent of taxable income:				
Top bracket	70	2.86	6.67	2
Lowest	14	14.3	2.3	2

Table I shows, for single brackets, how these alternative methods of changing tax rates (1) alter the tax burden, (2) effect disposable (post-tax) income, and (3) what relation they bear to total taxable income. To make the three methods comparable, it has been assumed illustratively that an equal amount of revenue can be raised (or forgiven) by (1) a 2-percent change in relation to taxable income, (2) a 2.5-percent change in relation to disposable income, and (3) a 10-percent change in relation to tax revenues.

Equal proportionate changes in taxes paid have a much larger impact, in terms of disposable income and in relation to taxable income, for income received in the upper brackets than in the lower. This follows from the fact that taxes paid represent a higher, and disposable income a lower share of taxable income in the higher income brackets than they do in the lower. Thus, the upper brackets would be relatively better situated, with respect to this form of tax change, in case of a cut and worse in case of an increase in taxes.

Equal proportionate changes in disposable income have an opposite bias. Their impact is greater in the lower brackets. Thus the lower brackets would be relatively better situated, with respect to this form of change, in case of a cut and worse in case of a rise.

The impact of the third method, tax change proportionate to taxable (pretax) income, falls between the two other methods. It may thus be regarded as a compromise between the two.

A fourth method may be considered that would operate only on what used to be the first bracket, that is, the first $2,000 of taxable income. This was the proposal of the Commission on Money and Credit. Since the great bulk of revenue is collected in this area, it would be quite an effective method.

It would strongly favor low-income taxpayers in case of cuts, since the high-income taxpayers would get a cut only for their lowest bracket rate. It would throw most of the burden upon low-income taxpayers in case of increases. This feature might create pressures against timely decisions to institute increases and seems to me to argue strongly against the device. The fact that the 1964 tax legislation meanwhile has split the first bracket into four moreover would complicate, although not fatally, the execution.

2. Limitations and qualifications

If a simplified procedure for tax changes is to be adopted, one that is not specially tailored to the precise character of each inflation or recession, nor to the equity and other considerations that would be relevant in case of a real tax reform, certain limitations should be imposed. Else there is a danger that these neglected considerations may be too severely or too enduringly overridden. Limitations are clearly appropriate if the power to make tax changes is delegated to the President. But wise self-limitations are desirable also if the Congress wishes to adopt some simplified procedure for anticyclical tax changes.

(*a*) *Rates.*—The Commission on Money and Credit and President Kennedy recommended a maximum change of 5 percentage points in the personal income tax. At approximately $2.5 billion per percentage point, that would amount to a cut of $12.5 billion at an annual rate. This sum seems large in most situations. It is of the order of magnitude of the great 1964 tax cut, which proceeded in two stages and included corporations. A smaller limit would be acceptable. Actual cuts and increases probably ought to be kept below 5 percent in most situations.

(*b*) *Duration.*—Any tax change under the simplified procedure should be temporary. That is necessary to insure that our tax system does not come to be determined by a sequence of emergency actions. That would be fatal from both the economic and the equity point of view.

A 6-month limit, again as proposed by the CMC and President Kennedy, seems sensible. A one-time extension subject to safeguards, for example, to a new congressional vote or veto, could be allowed for. Obviously this does not impose any rigid limitations, since the Congress can always review its decisions.

(*c*) *Tax holiday.*—As an alternative to the proposed limits upon size and duration of the tax change, a tax holiday might be considered for the case of a sudden severe recession. A tax holiday would suspend the withholding system for 1 or 2 months altogether. Taxpayers paying quarterly could make the corresponding adjustments on those dates. The suspension of withholding alone would release something like $4 billion of purchasing power each month. The holiday would have to be limited to a much shorter period than a 5-percent tax cut, say, to 2 months. It would be powerful antirecession medicine.

But while the tax holiday would end a recession more quickly than any other scheme, it nevertheless encounters serious objections. It would be a costly way of doing the job because the proportion of remitted taxes that consumers would spend probably would be smaller than in the case of a more enduring cut. Consumers, it is generally assumed, tend to hoard a good proportion of very brief windfalls.

The sudden financing of so large a deficit might create difficulties for the monetary system, at the time or quite likely later. The impact of so unorthodox a measure upon domestic confidence and upon the balance of payments is not foreseeable. At best, the idea would seem to deserve study.

(*d*) *Evidence of necessity.*—Tax changes must be instituted quickly when they are needed. But before simplified procedures can be justified, clear evidence of need should be had. President Kennedy accepted the proposal of the CMC that prior to taking such action, the President should make a finding that the action was needed to meet the objectives of the Employment Act. A similar finding should be available if action were to be initiated by the Congress.

This finding is difficult enough to make when all that is to be determinded is whether a recession or a burst of inflation threatens. Such events frequently involve a "recognition lag." The finding becomes much more difficult when the tax change is to serve as an instrument of the "new economics." Discussing the "new economics" in the latest Economic Report (p. 180), the Council says, very appropriately in my judgment:

> This approach to policy has several key aspects, not entirely novel by any means. First it emphasizes a continuous, rather than a cyclical, framework for analyzing economic developments and formulating policies. Stimulus to demand is not confined to avoiding or correcting recession, but rather is applied whenever needed for the promotion of full utilization and prosperity. Second, in this way, it emphasizes a preventive strategy against the onset of recession.

I assume that the Council would also want to extend this reasoning to the threat of inflation.

The Council's prescription requires flexible handling of tax rates. To that extent, the study undertaken by your subcommittee serves the purposes of the new economics. But there is a big difference between adopting quasi-emergency procedures to avoid going off the road, and taking them just in order to increase a little the precision of the steering while still in the middle of the road. The need for rapid action diminishes, the justification for delegation of powers to the President diminishes likewise. I recognize the desirability of having an instrument for precision steering. It seems less certain to me that shortcut procedures are equally justified under these conditions. I would suggest that, in the absence of a finding of impending recession or inflation, when all that is needed is a little more stimulus or restraint, a longer period for debate be allowed. Thus a period of 3 weeks might be provided for a congressional vote or veto in case of a finding of inflation and recession. A period of 2 months might be provided in the absence of such finding.

(*e*) *Congressional veto.*—If the power to change tax rates were delegated to the President, the Congress clearly should maintain a veto right for a given period. The Congress should also review the measure if the President proposes a renewal after 6 months. Under this kind of procedure, the role of the Congress would not differ greatly from that which it maintains vis-a-vis the regular tax proposals of the President. There is a difference, to be sure, between a veto and positive authorization following debate and amendment. But if the Congress contemplates simplified procedures initiated by itself, where debate and amendment would also have to be limited, the difference shrinks.

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3. Who should act?

Since Congress did not react to President Kennedy's proposal, based upon that of the CMC, to delegate very limited power over tax rates to the President, exploration has turned to the possibility of expediting congressional procedures. President Johnson has endorsed the suggestion in two successive Economic Reports. The difference between the two procedures, as well as the contrast of either with existing procedures, can easily be overestimated.

Many tax proposals are originated by the President. When the Congress acts upon them quickly, as it did on the tax proposals in the latest budget message, the difference in speed is minimal. What remains is the unpredictable and possibly irreversible character of the action. It contrasts with the predetermined and reversible methods now being studied by your subcommittee. These methods, untailored as they are to particular circumstances, are not necessarily ideal. On the other hand, quickly conceived and scantily debated ad hoc measures such as those taken now, with their uncertain reversibility, are not ideal either.

Assuming that the delegation of powers to the President can be discussed objectively without seeming to be lacking in respect to the historical prerogatives of the Congress, the following alternatives may be considered: (1) delegation of limited powers to the President, (2) accelerated procedures preserving congressional prerogatives, (3) no change in procedures but enhanced realization that under certain conditions speed is important, (4) an automatic formula to "trigger" tax changes, activated by major economic indicators such as unemployment, price indices, and the balance of payments.

The issue ought to turn on which method promises the best results. (I abstract from the economically sensible but politically unacceptable possibility of turning the matter over to the Federal Reserve.)

(*a*) *Formula flexibility.*—I would like to dispose of the automatic formula method first. The experience of the last few years has demonstrated that economic objectives may conflict seriously in the short run. Unemployment, for instance, can occur jointly with rising prices and with a balance-of-payments deficit. Under these circumstances it is probably impossible to work out a trigger formula that gives even approximate hope of throwing off the right signals.

A defective formula poses the danger of faulty action. At the same time, whether its signals are faulty or not, there is every prospect that the preset action will be interfered with in the light of unforeseen circumstances. The usefulness of the formula then is largely destroyed. In any event, it seems a counsel of despair for rational men to abdicate their judgment when there is no compelling need. Speedy action may be necessary, but it can be had by other means.

(*b*) *Unexpedited action.*—While nobody can fail to be impressed by the speed with which the Congress has acted recently, as well as on some other occasions, I am not convinced that this is the best that can be done. Situations have occurred in the past when lack of a systematic approach has impeded action. I believe that the deadlock over a tax cut that occurred early in the recession of 1958, with Congress and the administration both wanting a cut, but of different sorts, exemplifies this danger. A tax cut in 1958, even had it been only temporary, might greatly have changed subsequent economic history.

As between Presidential power and congressional streamlining, the pragmatic (as against the constitutional) issue is which side is more likely (1) to make the correct judgment, and (2) to act upon it expeditiously.

Recognizing the need for a tax increase is unpleasant for both the Congress and the President. To act on that recognition, however, is probably easier for the President, particularly in years when he does not have to run for reelection.

Recognizing the onset of a recession is probably harder for the President than for the Congress. Public admission is likely to be regarded as a failure of his administration. On the other hand, a tax cut will generally be a politically popular action. On that score, the danger may lie on the side of overeagerness.

Congress may at times be prevented from acting speedily because it may be not in session. This condition would raise a problem also with respect to a veto over Presidential tax action. Conceivably, the matter could be resolved by delegation to the tax writing committees of the House and Senate, which might reassemble if necessary.

On balance, the pragmatic advantages seem to me to favor delegation of limited tax power to the President, subject to the safeguards outlined earlier. If delegation is not feasible, the next best procedure would seem to be a decision by the Congress, after careful study, on the kind of tax change to be implemented if and when conditions warranted. Implementation then could take place by joint resolution.

A technique for flexible tax change would be a major innovation in American economic policymaking. It deserves the best thought we can give it. It is clear that such an instrument is needed if we want reasonable—by no means complete—assurance that full employment can be preserved. At some time in the Nation's history, I am confident, this instrument will be provided. The question before us is whether that time is now.

There seems to be very general agreement that we need an instrument of the sort that is discussed here, a kind of lever that will move tax rates up and down, somewhat analogous to the way the Federal Reserve, with a minimum of delay, can raise and lower discount rates.

I am sorry to say that I have nothing very much to add to this consensus. Broadly, my conclusions are these: We should have a limited flexibility in the personal income tax, say 5 percent up and down. It should be subjected to certain conditions to prevent errors of judgment and possible misuse. I don't preclude application to investment tax credit and corporate income tax, but see a substantial disadvantage at least in using the corporate income tax.

I see no great hope of developing new taxes of any kind that will lend themselves to this particular proposal, although for other reasons, some new kinds of taxes, such as the value added tax, might be interesting. As for the very thorny question as to who should activate the tax changes, if one may face up to this without disrespect to the prerogatives of the Congress, I would say that on pragmatic grounds, the President has certain advantages in terms of making this proposal operational on the upside, on the downside, and at times when there may be impediments for the Congress to act.

Now if I may, I would like to substantiate these conclusions. First, I agree very much with what has been said here before. We now have a body of experience that shows that fiscal policy is effective. We are not groping in the dark here with an instrument the effects of which we do not know. It is also true that monetary policy alone does not strike me as a desirable way of effectuating stabilization. Public expenditures deserve to be considered, but they have the well-known limitations of slow maneuverability, both on the upside and on the restraining side.

This, then, leaves us basically with three questions: One, what is the best type of tax to change? Two, what kind of limitations and what safeguards ought to be built into this system? And, three, who is to activate these changes, in case of need?

First, I think some red herrings need to be moved out of the way. It can, of course, be argued that every recession is different. Therefore, one can't in advance say what kind of tax change is the optimal change. Likewise, all inflations are different, and one does not know what kind of tax increase is optimal—against consumption, against investment, against some combination, of them, to be levied upon the upper brackets, lower brackets, or corporations.

On the other hand, we really do not know enough about the differences that these changes make. We have learned a great deal, and I think we have learned enough to use the instrument, but the refinements are obscure. Any tax change affects both investment and consumption, because investment and consumption react on each other. I therefore do not think that it makes a great deal of difference from the point of view of total effectiveness, which tax we change, even when we don't know in advance what the exact circumstances of recession or inflation are going to be.

This suggests, then, that we ought to look at the choice of taxes simply in terms of which tax change will do the best job of stabilizing. I do not see a great deal of importance in the equity argument here. We are talking both about reductions and increases. If these are made by the same system, then if somebody feels that his ox is gored by a cut, he would be benefited correspondingly by an increase, and vice versa.

What I think is extremely important is that the system be neutral, in the sense that it not get involved in reform, and that it works equally for increases and decreases in tax rates. Unless it does, there will be resistance on the side of those who feel that they have to lose. Then it may turn out that either the action is not taken, if it is to be taken by the Congress, or that it is vetoed by the Congress, if the President takes it.

I think we ought to distinguish quite sharply between equity and stabilization, and I feel morally comfortable with this proposition, because we do not know whether the changes are going to be up or down. They will probably be both. What is "inequitable"—in quotes—to somebody in one direction is all the more favorable to his interests in the other.

What are the best taxes to use? I think excises and social security taxes deserve to be ruled out. Social security involves the actuarial soundness of the system, and the insurance feature of the system. Everybody ought to make his appropriate contribution, which should not be affected by cyclical tax changes.

Excises, I think, are bad because excises are a tax that is shifted, that is passed on to the consumer in the price. Hence, they have perverse expectation effects. When a cut is expected because a recession looms, people will put off buying, and make the recession worse until the cut is in.

When the reverse is expected, an increase to stem inflation, people will hurry up their purchases and aggravate the inflation. That makes excise changes undesirable.

Granted there could be adjustments through retroactivity, then, however, the matter becomes very complicated administratively.

I am afraid this applies also to the value-added tax. I share with Professor Harberger a certain admiration for this tax, but for other reasons. I fear that some people other than Mr. Harberger and myself really like this tax because it is shiftable. If it were substituted for the corporate income tax, it would relieve corporations, probably, of some of the corporate tax burden. That ought not to be its objective.

The value-added tax also raises a serious problem of redistribution of the tax burden among taxpayers. Any corporation that does little buying of products on which the tax is already paid, say a hydroelectric utility, has little to deduct. Its total sales, therefore, are almost equal to its value added.

A corporation like that would be hit very hard by the value-added tax. A corporation, on the other hand, that did a lot of buying for inventory and processing, would have a large deductible. Its tax burden, compared to the corporate income tax, would probably be reduced.

But from the point of view that we are considering here, I think the main detriment of the value-aded tax, which otherwise I would favor, is that being more shiftable, it induces the wrong kind of expectations. When an increase is ahead, people will step up their buying and will aggravate the inflation. When a cut is ahead to stem a recession, people will delay their purchases.

I would also suggest that the corporate income tax has certain defects. The tests we ought to apply here are speed of reaction and minimum disturbance. The corporate income tax does involve some disturbance to business planning.

It is true that monetary policy also involves disturbance to business planning, when interest rates go up or down. It is worth noting, also, that changes in the interest rate involve a kind of tax on investment that is quite substantial. If a firm makes, say, a post-tax profit on its investment of 15 percent, and a pretax profit of 30 percent, an increase in interest rates of 1 percent affecting the full value of its investment means a 3 percent increase in its costs in relation to its pretax operating income. That is not insubstantial.

I would therefore suggest that corporations already are "taxed" as a result of monetary policy.

The consumer, of course, also is "taxed" when interest rates change.

There is one area that I think has not been examined. That is inventory taxation. Inventories are the most destabilizing factor in the business cycle. We have big swings from plus $10 billion accumulation to minus $10 billion decumulation. If some device could be developed to reduce these fluctuations, stability would be greatly strengthened.

Whether we could envisage a tax on inventory increases, I do not feel very certain. There are a great many obvious difficulties in it. There are difficulties, of course, in every new tax proposal. I think an inventory tax deserves to be studied.

Likewise, I think we ought to study whether we could not give a permanent tax credit to firms that maintain a stable inventory policy. This would have to be different from one industry to another, because inventories have inherently different stability in different industries.

Again, the technical difficulties are clear. But we have not given much thought to whether they could be removed. There might be a great payoff to further study of possibilities in the area of inventory taxation.

Coming back to the proposition that the personal income tax is probably the best, the fastest, and the least disturbing, we have to ask ourselves which of various kinds of tax changes is preferable. There are three familiar devices. One could change—as has been proposed here—the tax burden by adding say, 10 percent to the tax paid by everybody. One could change by an equal percentage the post-tax, i.e., the retained income. One could change the tax burden by an equal number of percentage points of pretax income—what appears in form 1040 as taxable income.

These things have very substantial differences in impact, as between brackets. Necessarily, something that changes the tax burden has the biggest impact in the upper tax brackets, and the lowest in the low brackets. I am referring here only to the income that is received in that bracket. I realize that a taxpayer who pays in the 70-percent bracket pays all along the line, his effective rate is a little more than one-half of 70 percent.

Looking only at the top bracket, a 10-percent change in tax burden means a 23.5-percent change in disposable income. In the lowest bracket, the 14-percent bracket, a 10-percent change in tax burden changes the disposable income by only 1.6 percent.

When taxes are raised, this is fine for the lower brackets. They pay little additional tax. My colleague, Professor Gordon, suggested that this might be the equitable thing to do. When we contemplate tax cuts, however, the upper brackets would get a cut from 70 percent to 63, which is a very large increase in their disposable income; the lower brackets would get a 10-percent cut in their tax, which is a minimal increase in their disposable income. If the system is to be equitable, clearly, its consequences must be accepted in both directions. The tax on disposable income works just the opposite. The same rate applied to top brackets and lower brackets affects the top brackets very little, and affects the lower brackets very substantially. The lower brackets therefore, are hurt badly by an increase and are benefited by a cut in taxes.

In between these two extremes, we have a tax proportionate to taxable income. This falls in the middle between the other two. That is how the percentages work. As a rough measure of justice, I would incline toward that third solution. The way to implement such a change proportionate to taxable income would be to raise all brackets by the same number of percentage points.

Incidentally, because the revenue yield of this third method is biggest, the rate of increase is lowest. One percentage point is worth $2½ billion in our present situation.

I now turn to the limitations and qualifications to be imposed upon upon anticyclical tax changes. Simplified procedures in the Congress, and even more particular powers are delegated to the President, must be circumscribed carefully. One limitation should be as to the circumstances in which this action can be taken. If action is to be taken against either recession or inflation, a clear finding ought to be registered that this danger exists. It should not be done on a hunch, nor because conditions politically invite such action.

Here we run into trouble with the New Economics. The New Economics goes beyond the simple device of raising taxes in inflation and cutting them in recession. The New Economics says that we should be steering along the middle of the road all the time. If the economy threatens to slow up a little, a tax cut is in order. If it threatens to move to the inflation side, a tax increase is needed. That kind of need is much harder to demonstrate. For example, in 1962: Did we need a tax cut to prevent a recession? We did not get a tax cut. It turned out we did not strongly need it then to prevent recession. We did to reach full employment.

Those judgments are much harder to make. My suggestion would be to institute a longer period of debate for the Congress under those conditions. If the President were to be empowered to act, let the Congress have a longer period to veto his action, which again means more debate.

I would like to consider at this point the possibility of a total tax holiday in case of recession. That would suspend all withholding, for a month or two. This would be tremendously powerful medicine. It could not be continued for long, because the Government would remain almost without revenues. But while this technique would end a recession much more quickly than any other device, it is a very expensive way. Nobody knows what part of such a tax cut people would spend. This remains uncertain, even in case of a limited duration tax cut, say for 6 months. But if the duration were 1 or 2 months, the percentage of forgiven taxes spent might be quite low.

The veterans' bonus of 1936 is an example of how people apparently do not spend windfalls very generously. Still, the tax holiday deserves to be put on the docket as a possible type of action.

Finally, the question, who should take action? I have indicated at the beginning that in my view the President has certain advantages. When the Congress isn't in session, he can act. Conceivably, the tax-writing committees could, of course, act on behalf of the Congress, or Congress could come back into special session. I think the political pressures, if it is appropriate to mention this, are probably less on the President at most times than they are on Members of the Congress, particularly those who have to run for reelection every 2 years.

In terms of ability to recognize the existence of a need for action, the President may have a slight advantage, although with an instrument like the staff of the Joint Economic Committee at hand, the Congress also could make very rapid determinations.

Possibly the difference isn't very great between Presidential and congressional action. In the case of the recent tax increase, the initiative came from the President. The President originated the proposal. It went through very very rapidly. This approach is not so different from Presidential power to institute a limited, say, up to 5 percent, tax increase and cut, subject to congressional veto.

I do not know therefore, whether we have a great deal to argue here. The important thing, clearly, is that the Nation finally get this instrument. I am sure someday it will get it. The question is whether we can put it over now.

Representative GRIFFITHS. Thank you very much, Dr. Wallich. And I want to thank each of you gentlemen for your excellent statements.

I happen to have been sitting on Banking and Currency when the original proposal was made by a group of rather conservative people, a commission on banking and credit, to give the President the power to cut or increase taxes. Now I believe it was about 8 years ago that this proposal was made. It may have been less. But if it were 8 years ago and if the power had then been given, under the circumstances that have existed in the past 8 years, in your judgment, how many times would the President have used the power to either increase or decrease taxes?

And I ask you first, Mr. Gordon.

Mr. GORDON. Madam Chairman, he certainly would have used it in 1962. He asked for that power then.

Representative GRIFFITHS. What about 1958?

Mr. GORDON. I have said in public that we now realize that that is when we should have begun to use this type of stabilizing fiscal policy. Had I been an adviser to the President, I would have recommended that he use it in 1958; yes.

Representative GRIFFITHS. All right. Do you believe he would have cut them in 1958?

Mr. GORDON. Yes.

Representative GRIFFITHS. In 1962, would he have cut them?

Mr. GORDON. It would depend on what the effect had been in 1958. I am sure you don't want me to start a standard lecture I have on what was wrong with the state of private business investment opportunities after the investment boom of 1955 to 1957. A cut of the sort that the late President Kennedy proposed in 1962 would undoubtedly have done some good in moving us out of the 1958 recession more vigorously than did in fact occur. I am not clear in my own mind that that would have been enough. It would have depended on how private investment behaved. We had just begun to experiment, then, with more generous depreciation allowances and further incentives to private business investment were to come only later, in the early sixties.

It is my guess that a further cut in taxes, in the absence of stimuli to business investment, would have been necessary in the early sixties.

Representative GRIFFITHS. Thank you. Would you like to estimate what you think would have happened, Mr. Shoup, if they had had it for 8 years? What would the President have done?

Mr. SHOUP. That is, in the sense of what should have happened, not what would actually have happened.

Representative GRIFFITHS. That is right.

Mr. SHOUP. In terms of what should have happened, I would say that in my view, the President, having such power, should have put in a tax cut in the 1957–58 period, a very substantial one. Had he done that, conditions of course would not be the same in 1962 as they were. But supposing that no such action had been taken in 1957–58, I believe the President should have decreased taxes in 1962. The rate of unemployment was still so high that even apart from temporary business cycle influences, tax relief seemed to me clearly called for at that time.

Representative GRIFFITHS. Would you care to answer, Mr. Harberger?

Mr. HARBERGER. I am afraid I have nothing to add to what my colleagues have already said. I certainly agree with it.

Representative GRIFFITHS. All right, fine. Mr. Wallich, would you care to answer?

Mr. WALLICH. In 1958, I believe that the administration wanted a tax cut oriented toward investment, and I understand the Congress suggested that if there were to be a tax cut, it would have to be directed toward consumption. Hence, they arrived at the famous unwritten agreement at top level not to do anything?

My own view is that had a system of this kind been available that was reasonably neutral as between consumption and investment, it might very well have been used, because early in 1958, nobody was worrying about the balance of payments. Later, the balance-of-payments deficit became an obstacle—possibly overrated—to the institution of a tax cut.

In 1962, it seems quite clear that President Kennedy would have used the power. Having first argued that we needed a tax cut for structural reasons, because the full employment surplus was too large, he then observed recessionary tendencies in the economy. He then employed the argument that not only did we need a tax cut for structural reasons, but also because of the immediate dangers to the economy. It turned out that these dangers were overcome without a tax cut. They would have been overcome more quickly, I am sure, with a tax cut.

Representative GRIFFITHS. Well, now, if we are either to give the President the power, or if we ourselves are to cut or increase taxes to stimulate the economy, or ward off inflation, may I ask how frequently do you assume this power is going to be used? Would you say it will be used annually, do you think that we are going to get good enough so we aren't going to have to do anything more than once every 5 years, or what do you assume is going to happen?

May I ask you, Mr. Gordon?

Mr. GORDON. I would assume that perhaps the power would be used more than once every 5 years. If we are lucky, with or without the kind of flexible fiscal policy that we are now discussing, there will be from time to time the opportunity to cut taxes across the board, to reduce the so-called full employment surplus, according to some formula.

As I suggested in my statement, I would like to see the President encouraged or empowered to make proposals of that sort in the Economic Report, which provides a good opportunity.

Representative GRIFFITHS. I thought that was an excellent suggestion, too.

Mr. GORDON. In addition to that, the President, with the help of the Council of Economic Advisers, anticipating accelerations or decelerations in growth, may want to suggest an acceleration of the long-range program of tax reductions, or retardations of such a program, and here, I think, is where the opportunity also arises to tailor-make the specific proposals to specific situations. Thus, in a situation like that today, if the President had some authorization to propose reductions across the board in the individual income tax, he might also at this time be encouraged to come in with some sort of tax proposal to retard the rapid expansion in private business investment. So that to come back to your question, I think that the authority might be used more often than once every 5 years, and I would hope that we would work toward a program where long-range planning of fiscal policy could be combined with a flexible policy involving possibly more than one type of tax, to help control short-run changes.

Representative GRIFFITHS. If we are to have ups and downs in taxes, do you think that it would have a diminishing effect, or would the people become accustomed to it and either spend or save their money in accordance with the tax policy?

Mr. GORDON. If these changes occurred, once every year or two or three, and not every 3 to 6 months, I don't think it would have—I am guessing—I don't think it would have important changes in the short-run behavior of personal saving rates. And for the great body of consumers, while consumer credit helps them to some degree to spend what they don't have, in general, their spending would be closely related to their income after taxes.

Representative GRIFFITHS. May I ask you why none of you have said anything about consumer credit? It seems to me that if people are guaranteed employment the terms under which they pay can be extended; that you are not apt to cut down personal consumption with a tax increase.

Mr. GORDON. Madam Chairman, I took my assumed terms of reference quite strictly. This was to be concerned with fiscal policy. I have long been an advocate of giving to the Board of Governors of the Federal Reserve System the power to change the terms of consumer credit, and I wish they would stay continuously in effect.

Representative GRIFFITHS. Thank you.

Senator Proxmire?

Senator PROXMIRE. In view of what did happen in 1964—taxes were cut, there was a presidential election, the party that cut the taxes won an overwhelming victory—would you not revise, Mr. Gordon, your estimate of every 5 years to an every 4-year tax cut? [Laughter.]

Isn't it very tempting? I don't want to be too cynical, but isn't it very tempting for a President in an election year, if he has this kind of power—and he would have power to initiate it—to make the voters a present of reduced taxes.

Mr. GORDON. Obviously, and it is very tempting for Congress to go along with him.

Senator PROXMIRE. And conversely, isn't it much more difficult in an election year for a President to increase taxes?

Mr. GORDON. Perhaps I will answer that in two parts. Hopefully, we would have the kind of President——

Senator PROXMIRE. We have only had that kind of President in the past, and present—but maybe in the future——

Mr. GORDON. One advantage I would hope for from my proposal, that the Employment Act possibly be modified to instruct the President to come in with fiscal recommendations in each Economic Report; would be that it would help to educate the White House, the Congress, and the voter to be ready for this sort of thing in both directions.

Senator PROXMIRE. And you have suggested that this be done in January?

Mr. GORDON. Yes, sir.

Senator PROXMIRE. And then, as I understand, I think you were the one who suggested that the tax change might first be passed on by this committee, and then go to the tax-writing committees, and then be debated on the floor, and then be acted on by the House and then by the Senate. Isn't there a long political lag here added to the technical economic lag?

Mr. GORDON. Quite. It involves some medium-term forecasting, on the part of the administration, as to what is to be the course of economic activity over the next 12 months. But this, we are being told, either explicitly or by implication, through the Economic Report today. I would hope that if the President had recommendations of this sort to make in January that, during the course of the next couple of months, the debate over his proposals could be gotten out of the way, and the legislation passed, which would still not necessarily bring about the tax change but would provide the standby authority, so that then in a matter of, hopefully, a few days, if the forecasts turned out to be correct, the change could go into effect.

The President would also be free, under my suggestion, to come in at times between Economic Reports, with additional recommendations, which again would have to be debated, and which might take the form of an immediate tax change or simply an alteration in the standby authority.

In this respect, it occurs to me that, in seeking some sort of formula for fiscal flexibility, it might be possible to work out some sort of authority, possibly to the President, regarding the personal income tax; but he would be invited and encouraged to make additional proposals through the Economic Report, or on an ad hoc basis, for changes beyond the range of authority given to him, or with respect to additional types of taxes.

For example, if Congress had chosen to give the President the authority to vary taxes within 5 percentage points, up or down, modifying the suggestion made by President Kennedy, the President might at this time, or at least if the Council of Economic Advisers becomes a little more alarmed than they apparently are now, propose within his authority an increase in the personal income tax of a certain number of percentage points, subject to veto by Congress and, in addition, following the suggestion that a number of us have made, suspension of the investment tax credit for 1 year, or whatever.

Senator PROXMIRE. It occurs to me that you have the political lag. You can modify that to some extent, if you give the President some discretion. I don't think the present mood of Congress is to do that. It may be, but I doubt it very much, and I doubt if it is going to be for some time; but maybe, as Mr. Wallich has said, and others have said, it is going to come eventually.

But, added to that, I wonder about this technical lag.

You mentioned the investment credit, and the Treasury tells us that there is a lag of 9 months to a year. Mr. Shoup says 9 months. I wonder, under these circumstances, if we might have the same experience we have had at times in the past with the Federal Reserve Board, where they were going just in the wrong way, leaning with the wind instead of against it. We haven't had a very reassuring experience, it seems to me, with economic policy forecasts in the medium, interim period, over a very long period. It is true they have been pretty good lately, in the last few years. But I just wonder if we should not wait a little longer to see if our forecasting can't prove itself a little more before we do anything as drastic as has been suggested here today and yesterday.

Mr. GORDON. Well, granted your point, Senator, it seems to me, with respect to the proposal that standby authority be created now, that there is no harm from anyone's point of view, except as it may, for the good, mildly lead to a little bit greater caution in the business community, thinking that perhaps this will actually be approved later in the year, with respect to the investment tax credit.

Senator PROXMIRE. Well, I am not so sure. Dr. Wallich indicates that, if they think later in the year they are going to get a tax increase, there might be a tendency to buy now and get in under the wire, under some circumstances—to move ahead before they are hit by the tax.

Mr. GORDON. Excuse me, Senator, but he was talking there about excise taxes, I believe.

Senator PROXMIRE. That is correct.

Mr. GORDON. I am talking about income taxes. If consumers generally are being told that they are likely to get an increase in their personal income tax, and have less income to spend the second half of the year, they may do a little more saving now, which is just what we want them to do.

Senator PROXMIRE. I understood you to suggest that you favored a tax increase, provided you could couple that with an easier monetary policy. Did I misunderstand that?

Mr. GORDON. In general, you suggest the direction of my opinion. I do not think that credit should be tightened further, and if we got the tax increase it might be wise for the Federal Reserve slightly to ease it. What I am fearful of, and don't want to see happen, is further monetary tightening.

Senator PROXMIRE. Yesterday Professor Buchanan took a similar position to yours, but came out against a tax increase not on the ground that he wouldn't like to have it, but on the ground that he cannot control Governor Martin. You probably would get a tax increase and a further tightening of money. Under the circumstances, rather than risk that, he would prefer not to have a tax increase. He thinks the present tight money situation is beginning to retard the economy in some respects.

Mr. GORDON. It is; but I am afraid that he, no more than I or Mr. Martin, can predict the longer run and indirect effects of the tightening that is now taking place; and, as I have said, I am fearful that a still further tightening may have consequences that we all will regret.

And this is why it seems to me important to get some kind of fiscal tightening in the next 6 months or so.

And, in this respect, may I respectfully urge that we are really discussing two topics. One is how should we move toward a flexible fiscal policy, whether we get it today or next year or 5 years from now?

The next question is, what in the interests of the economy should be done in the near future? And in the near future I respectfully submit that I think there ought to be some fiscal tightening, even though in the longer run we might work out a better formula for doing it than what we are likely to get today.

Senator PROXMIRE. May I ask the other three members of the panel this question, because I want to be sure I understand your positions. I know Mr. Harberger at least expressed himself, but I would like to ask Mr. Shoup and Mr. Wallich and Mr. Harberger whether each of you now favors a tax increase, and whether you would condition this position of support or opposition to a tax increase on monetary policy or any other development?

Mr. SHOUP. Well, as of today, I do not favor a tax increase, but I recognize that if present trends continue, it may well be desirable to have one before the year is out.

Senator PROXMIRE. Mr. Harberger?

Mr. HARBERGER. Well, in my statement, I concentrated consciously on the value-added tax. I would like to add only that if the value-added tax, for one reason or another, would not be acceptable as a component of our fiscal system, I definitely would prefer, rather than nothing, to introduce some kind of flexibility through the income tax. I find that income tax changes are more fraught with political and other difficulties than would be value-added tax changes, and I therefore think that a value-added tax is the easiest and best way to get this kind of flexibility, but if you cannot get it via the value-added tax, I would certainly prefer to have it via the income tax.

Senator PROXMIRE. I don't want to press you too much, but I want to know if that answer means that as of today, you would favor increasing personal income taxes if you cannot have an increase or can't have a value-added tax?

Mr. HARBERGER. My own judgment of the present situation is that it is sufficiently touchy and sufficiently inflationary that a repeal of the tax credit would be warranted. I would not be prepared to say that in addition to such repeal, an immediate rise in income taxes is justified, but I would think that circumstances may develop such that within the remainder of this year, such an income tax move would also be required.

Senator PROXMIRE. You aren't bothered by the lag in the impact of the investment credit, or did you dispute that there is the lag that the Treasury and Mr. Shoup point out?

Mr. HARBERGER. I think that almost any tax measure that we could enact would have some kind of a lag associated with it. I think that the investment credit is the kind of thing on which action could be taken quickly, and without a great deal of difficult debate inside of Congress, so you would be saving time at that end.

Now, I am willing to agree that perhaps the average timelag between the repeal of such a credit and the average response might be as long as 9 months, but I certainly believe that there would be some reaction visible immediately.

Senator PROXMIRE. My time is up. With the permission of the chairman, could I ask Dr. Wallich to respond, as long as three of the members of the panel have replied? If not, I can come back to him later.

Representative GRIFFITHS. Mr. Widnall?

Mr. WIDNALL. I am going to have to go to the House.

Representative GRIFFITHS. All right. Mr. Widnall, you are recognized.

Mr. WIDNALL. Thank you, Madam Chairman.

Mr. Harberger, I am intrigued with what you said about the value-added tax, and the fact that it has been in effect in France since what, 1957–58?

Mr. HARBERGER. 1954.

Mr. WIDNALL. How effective has it proven in France?

Mr. HARBERGER. Well, it has proven to be—let's say it has become the most important single component of the French tax system. The French have not used the value-added tax as an instrument of a flexible fiscal policy. They have not changed the rates up and down. But as a viable component of a tax structure, it has more than proved itself.

Mr. WIDNALL. Haven't consumer prices in France had a tendency to go up to compensate for the increase in tax through that tax?

Mr. HARBERGER. Oh, there can be no doubt whatsoever that this is the kind of tax that is going to have an effect upon consumer prices, but it seems to me to be a matter of relative indifference whether we reduce consumer income by taking income away from them and facing them with the same prices as before, or whether we reduce consumers' real income by a tax measure that happens to work through a rise in the prices that they actually pay. It is not an inflationary rise in prices that is induced by the value-added tax, or any other indirect tax. It is rather a method through which the taxes are being paid.

Mr. WIDNALL. I am just thinking about the political aspects. We are continually concerned with exempting the low-income person from further taxation, and trying to do things that are going to help the low-income person, but take from those who are better off, and are in the higher income brackets. It has certainly been my observation that every time we are doing this, we find prices go up, and the low-income person is paying through higher prices something that he is not being taxed for by way of an income tax. I don't see that the exemptions really amount to much in the end, but for political purposes, they sound good. When you say we are exempting a certain group, the exemptions always get passed along in higher prices. Wouldn't you agree with me on that?

Mr. HARBERGER. Well, there are certain taxes in the system that do tend to get passed along in terms of higher prices, but I think that the great bulk of our taxes, both income taxes and corporation taxes, are not so passed on. I think, moreover, that, in looking at a tax structure from the standpoint of equity, we should realize that it isn't the individual tax which is ultimately the appropriate object of our attention. If we are looking at the equity of the tax system, we should look at the whole package of taxes put together. Thus, if we were to have something of the order of the value-added tax, which is a flat rate kind of thing across the board, one way of compensating whatever effect that might have on income levels would be a sort of once and for all restructuring of our personal income tax, so as to make it somewhat more progessive, realizing that a major or proportional component is introduced into the system with the value-added tax.

Mr. WIDNALL. Well, I think it would be a healthy and constructive approach; we should fully consider it, and see what we can do about it.

I would ask all of you to give thought to this and comment on it. What indexes of economic activity would you suggest be relied upon to indicate the need for temporary tax changes?

Mr. Wallich?

Mr. WALLICH. On the down side, unemployment, principally. When unemployment rises significantly above 5 percent, I think we ought to consider seriously whether action is needed. This depends not only on the level, but on the rate of movement. If unemployment rises from 4 to 5 percent under conditions that plainly indicate that a recession is under way, then we ought to act before 5 percent is reached.

On the way up, it should not only not primarily be the unemployment rate, but the behavior of the price indices. When you have an acceleration of the Consumer Price Index, particularly the Wholesale Price Index, in its more sensitive compartments, then we may have to act even though unemployment is still not down to the levels to which we would like to get it. Personally, I feel that in the long run, we can keep the unemployment rate substantially lower than it is now, but that time has not yet arrived. At the present time, I think the reasonably noninflationary unemployment rate lies between 4 and 5 percent.

Representative WIDNALL. Would you care to comment on that, Mr. Harberger?

Mr. HARBERGER. I think that there are a lot of indicators of importance. The unemployment rate and the price level are obviously key ones, but we also now have increasingly reliable data on investment expectations, on new orders, unfilled orders, freight car loadings, inventory movements, and so on, all of which can be looked at as sort of separate indicators of where the economy is going. And it seems to me the consensus of professional opinion on this matter is that it is better to rely on these as a group—when these indicators begin to all tell you the same story, you can be pretty sure that that story is correct. And even if there isn't quite unanimity among all the indicators, but if 15 out of 20 key indicators are saying that you have an inflation problem, or that you have a deflation problem, it seems to me the time for action is at hand.

Now, I would like to add one point which has not been mentioned here, and that is the balance of payments. The balance of payments has been a problem in the United States in recent years, and it is likely to be a problem at various times in the future, and it is quite important from the standpoint of the mix of monetary and fiscal policy that one is likely to use. For example, a general reduction in income taxes is going to stimulate further importation, and is going, thereby, to tend to deteriorate the balance of payments.

In some cases the use of monetary policy, for example, tightening of monetary policy, has the effect of raising interest rates higher, and promoting capital movements from foreign countries to the United States, and thereby, easing the balance of payments.

It seems to me that in judging which particular instrument we should use, in combating a particular type of crisis, the balance of payments could not be neglected.

Representative WIDNALL. Professor Shoup?

Mr. SHOUP. We face a very difficult problem there, certainly. What we want to do is to prevent increases in consumer prices, on the one hand, and to prevent an unacceptable level of unemployment on the other hand. And the fundamental issue is do we wait until those things have happened, and then act? Or do we act on the basis of forecasting that tells us they are very likely to happen, though they haven't happened yet?

Suppose, for example, that we have had no substantial rise of consumer prices, but 15 out of the 20 indicators tell us that if we don't do something, we will have one in the next 6 months or a year. I confess I am somewhat puzzled at the moment as to precisely what policy we should be guided by. One must indeed respect our forecasters' abilities to see ahead a bit. They have remarkable instruments and analytical powers.

On the other hand, I think that they themselves would admit that if we try to look ahead more than 3 to 6 months, it gets a little cloudy, and, therefore, I am inclined to err on the side of caution and suggest that while we look at all the indicators, and maybe take action even before prices have risen or unemployment has developed, that on the whole, we do better to couple this approach with waiting a bit, even at the cost of allowing some damage to be done before we take action.

Later on, as we get more experience in this, let us hope that we may be able to act before the event, and keep the economy on a stable price level with something approaching full employment, by means of anticipatory tax measures. I am not as confident as I would like to be that we are in the position yet to go quite that far.

But the action should be prompt, nevertheless, once the basic indicators show the prices up or employment down.

Representative WIDNALL. Thank you. Would you care to comment, Professor Gordon?

Mr. GORDON. I would like to distinguish between indicators or indexes to guide current policy action, on the one hand, and what we think are the objectives we are striving for in using any particular fiscal and monetary policy on the other. We think of our objectives as being concerned with employment and unemployment, the rate of growth of the real gross national product, and the stability of the price level, subject to the important balance-of-payments constraint. But I would not view any one of these, its observed past behavior, as the guide to current policy action. I do not believe in being guided by a single or some small group of indicators. We should be continuously evaluating the current and prospective economic situation, and out of this evaluation, reaching judgments, not perfect by any manner or means, as to what seems to be appropriate action for the future.

And if I may, in that connection, I should like to offer the following suggestion, although I hate to make additional work for my friends on the Council of Economic Advisers. I should like to see us move toward a procedure under which the Council would each quarter make a forecast for another 12 months ahead. They have in effect made one, in January, for the calendar year 1966. A couple of months have gone by. Undoubtedly, they have new ideas on the situation. At least I, from a great distance, am not clear as to what these highly qualified people now really think about the situation for the next three or four calendar quarters. I think that the Joint Economic Committee, the Congress, and the public at large, would benefit substantially if there were a continuous official reevaluation of prospects for the year ahead, perhaps on a quarterly basis. And this, much more than the behavior of a single indicator, would help us make up our minds as to what might be appropriate action.

Representative WIDNALL. That, too, seems like a very constructive suggestion.

Madam Chairman, my time is up. I did want to ask one other question. I would like to have somebody ask it, in my absence, as I have to go over to the House.

Representative GRIFFITHS. Ask the question.

Representative WIDNALL. It is how effective would be a tax change known to be temporary as compared to one designed to be permanent?

Representative GRIFFITHS. Would any of you like to answer, please?

Mr. SHOUP. If I may address myself to that point, an income tax change that is fairly substantial, on the order of 10 or 15 or 20 percent change, would, I think, be fairly effective in checking or stimulating consumption, even though it were known to be temporary, and even though it were known that this would recur in future cycles, and I base this largely on the fact that I believe that the great bulk of the purchasing power is in the hands of households who don't have a great deal of quick short-time flexibility in the sense of being able to continue consumption patterns for long when their basic disposable income has been altered very quickly. Obviously, if authorities in other parts of the Government themselves act in a way that tends to offset the tax change, then what I say is not of much importance, but I am assuming that the Government policy throughout is consistent, and that therefore, consumption spending will react fairly strongly, even to temporary changes—if by "temporary" we mean something that is expected to last for a year or two, not, of course, only 2 or 3 months.

Representative GRIFFITHS. Would anyone else care to answer?

Mr. HARBERGER. I would like also to respond. I think there is a distinction that should be drawn between the use of direct tax changes or indirect tax changes in this respect. This was alluded to by Professor Wallich in his presentation. He mentioned that the movement of excise taxes as an anticyclical or flexible fiscal policy had certain defects, in that people would anticipate the tax changes and perhaps take certain actions in the wrong direction. Granted that this anticipation effect exists, it is also true that if you are facing a 10-percent extra tax on new cars, and you expect that that tax is going to be taken off in a relatively short period of time, you are going to have a stronger incentive to respond in a negative direction—to stop buying news cars right now—than you would have if you expected it to be permanent.

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Now I think that the broad-based indirect taxes of the type that I talked about have the advantage in the sense that you get some of this effect without getting too much. Operating with broad-based indirect taxes, like the value-added tax, you are talking about changing a tax by 1 percentage point, or half a percentage point, or one and a half percentage points, and getting quite a lot of fiscal mileage out of these small changes. I think that the direction of their effect is in the same direction as that of the bigger excises, but that the outcome might not be so exaggerated as to itself constitute a serious problem.

Representative GRIFFITHS. A value-added tax isn't really neutral between income brackets, is it?

Mr. HARBERGER. It is equal proportionately on all income brackets.

Representative GRIFFITHS. Well, doesn't it really fall most heavily upon the person at the lowest level? It acts like a sales tax, doesn't it?

Mr. HARBERGER. It depends a bit on the nature of the value-added tax. A value-added tax of a GNP type falls equally on consumption and investment expenditures, and in that sense, is across the board, since it is catching the savings through the taxation of the investment expenditures. If you have a value-added tax of a consumption type, it is proportional according to consumption, and since consumption is somewhat higher in the lower income brackets, it would tend to be somewhat regressive. On these grounds, I would prefer a value-added tax of the GNP type, which does not have any regressive component.

Representative GRIFFITHS. Well, France is not really a model of an anti-inflation nation, is it? It is not a very good model to use, would you think, from that standpoint? Evidently they haven't worked their value-added tax very well.

Mr. HARBERGER. Well, no individual tax is itself responsible for stopping an inflationary process. The issue with inflation, the fiscal issue in an inflationary process depends predominantly on the budget deficits, and you can have a budget deficit regardless of the structure of your taxes.

Representative GRIFFITHS. Now I notice that each one of you ruled out social security taxes—payroll taxes—and I would like you for a moment to reconsider that. I believe you ruled it out on the basis that it would interfere with the trust fund. Of course, the trust fund could be reimbursed out of the general funds of the Treasury, without any problem. And I would assume, also, that you could set the tax so that it only fell upon those who were drawing $2,000 or $3,000, or something above that.

In addition to that, you could move the tax up in times of a too buoyant economy. You could penalize employers for employing, or by reducing the tax, you could reward them for employing. Why isn't it a better method, as a countercyclical device, than the income tax? Would you care to answer?

Mr. WALLICH. Madam Chairman, this proposal was actually made by Lord Beveridge, many years ago, in his plan for postwar England. It is a very respectable and defensible proposal. Aside from the difficulties that I see, in the way of unsettling the actuarial situation of the trust funds which you say can be removed through a charge to the general fund, there remain the problems raised by Professor Gordon.

He said, I believe, that this might lead to differentiation in contributions of individuals, over their lifetime, in a system that makes at least a pretense of being an insurance system, although it is not exactly. There is also, I think, some danger of upsetting pricing policies, and perhaps engendering adverse price expectations, because the employer portion of the social security tax, of course, is borne by the employer and would be shifted through higher or lower prices. The effect would be that of a change in excise taxes.

Representative GRIFFITHS. Thank you.

Would anyone else like to comment?

Mr. SHOUP. There is one further technical point we might note, and that is that the existing payroll taxes have a ceiling above which they don't apply, and we would, therefore, be adding a very disproportionate burden on the moderately low income groups, it seems to me, even if we arranged somehow to have those below $2,000 or so exempted.

Representative GRIFFITHS. Of course you could remove the ceiling for these purposes without any problem.

Mr. SHOUP. Yes.

Representative GRIFFITHS. I might say that upon investigation, I discovered that originally, the ceiling had covered 90 percent of all those employed, and it does not even come close to that today.

Mr. SHOUP. Yes, I believe we would find, however, once we had shaped our payroll taxes up for anticyclical purposes, we would have an entirely new type of payroll tax that didn't much resemble what we now call the social security taxes.

Representative GRIFFITHS. May I ask you, Mr. Shoup, if you would care to add anything to your description of the cycle of tax changes that would enable you to decide that depression has ended, and therefore, we can change the tax structure, or when recession had actually occurred, or depression signs were occurring?

Mr. SHOUP. No, I think perhaps not at the moment, because I was not addressing myself here primarily to the problem of the proper indexes to use to designate the times at which changes should be made.

If we were in a depression, and had not succeeded in preventing rather severe unemployment, I would prefer to wait until the recovery had proceeded to the point where the unemployment index was fairly low, perhaps below 4 percent, before restoring the normal tax structure. I would hesitate to check the recovery by a too early rescission of the tax cuts that had been made. But I would agree with what has been said here that we cannot look at any one index. We have to be continually attempting to forecast, and if, for example, the unemployment rate had dropped to, say, 4.2 percent, but there was every evidence of a tremendous investment boom ahead, then indeed, we might move right away to rescind the tax cuts, and restore the normal structure.

Representative GRIFFITHS. May I ask you, Mr. Wallich, how you would anticipate an inventory tax operating?

Mr. WALLICH. I would contemplate putting some kind of a surcharge, perhaps a flat percentage rate, on corporate taxes, geared to the increase in inventories, during a period that is designated. This would have to be done in terms of the increase or reduction of inventories in relation to sales. In a period of expansion or contraction, clearly, some change in inventories is needed, but there is no need for destabilizing the inventory-rate ratio.

As to the definition of inventories, there ought to be no great difficulty, because that is something needed also for regular income tax purposes. The Internal Revenue has worked out the procedures. As to effects of price changes, there is a real problem. For a firm is not on the so-called "lifo" basis—last in, first out—changes in the price, say, of copper, make a great deal of difference to the price of copper inventory. There is a question whether a firm should be penalized for that. Possibly, this could be dealt with by shifting accounting methods to the "lifo" basis. This minimizes the impact of price changes.

I have also thought of allowing a credit analogous to the investment tax credit for firms that maintain their inventory at a stable inventory-sales ratio.

The standard would have to differ from industry to industry. That again is not a very different thing. The Internal Revenue also applies different useful life standards for depreciable property. It should be possible to work this out technically. Whether the results would be good enough to make all these complications worthwhile is something that ought to be studied, and I am certainly not endorsing this idea without a lot more study.

Representative GRIFFITHS. Thank you very much.

Senator Proxmire?

Senator PROXMIRE. Dr. Wallich, did you want to reply to the question which was how do you stand on a tax increase at the moment?

Mr. WALLICH. Well, I would say that we run very serious risks without a tax increase now. My favorite plan would be 2 percent across the board in all income tax brackets, and a suspension of one-half of the investment tax credit. Suspension of one-half, I propose, because I am afraid the credit would never be put back in if we suspended it 100 percent.

I am indebted to you, Senator, for a point that had not occurred to me before. The investment tax credit also seems to be subject to perverse expectation effects. If we talk long enough about suspending it, business will make sure that they have bought ahead and contracted ahead. Then under Senator Gore's procedure, allowing a period of grace to equipment already contracted for, the effect will be very, very delayed.

On the other hand, not to give a period of grace would be very rough, and might create hardships. The alternative is tighter money. I have never been an opponent of high interest rates, but when I saw certificates of deposit go from 4½ to 5½ in 2 or 3 months, I wonder just what this means for the soundness of the banking system. I think we are going at great speed in an area in which we don't know the way. I would much rather go slower on tightness in the banking system.

Senator PROXMIRE. I realize that you are giving us economic advice and not political advice, but I have to point out that the vote on the Gore amendment was 10 to 78. It didn't seem like there was much sentiment for repealing the investment credit. The administration was strongly against the Gore amendment and they made some very strong arguments on it. I suspect that even if they reversed their position, it would be difficult to get the Congress to change its mind, when it is that decisive.

Under these circumstances, would you modify your income-tax proposal from a 2 percent to 2½ or 3, or something of that kind?

Mr. WALLICH. I think the difference is hardly worth making a change. The one-half of the investment tax credit will be worth, I believe, $1 billion. Now, I don't know enough about whether we need constraints of $5 billion or $6 billion.

Senator PROXMIRE. Would you feel that you would have to have some kind of additional fiscal compensation because you could not reduce the investment credit?

Mr. WALLICH. I think we might contemplate 2½ percent. Three percent on the personal income tax would be $7½ billion. That strikes me as high. If the Internal Revenue people don't think that that is too complicated to work with half percentages, I think that might be a good thing to do.

Senator PROXMIRE. I am concerned. I expressed this yesterday, and I see today there is another straw—admittedly a small but I think maybe significant straw—in the wind. The Wall Street Journal reports that tight money begins to curb the construction industry's resurgence, and they point to a Dallas developer who says he has pared his earlier estimates of a 15-percent increase down to 5 percent. A Chicago area homebuilder who has figured on a 5- to 10-percent gain now expects only to match his 1965 volume.

Also, the remarkable expansion of plant and equipment which has resulted in not very much closer to capacity operations now than we were last year; it is still only 89 to 90 percent. A remarkable resilience in the labor force, because of the manpower training and employer training; it seems to me we have an availability—in many areas, at least—of labor. My own city of Milwaukee is not in that category. We have a serious labor shortage, and yet there doesn't seem to be the kind of pressure on wages that many people had anticipated. A report yesterday that inventory accumulations were not significant did not indicate a hoarding attitude; a leveling off of profits. Then the remarkable analysis that I saw just a while ago that, in the Korean war, prices arose in the first year or so when obligational authority was increasing. Then obligational authority began to fall off, and we expect it to fall off next year—it may not, but we expect it to—prices came down. When you put all these things together and then look at the stock market, which now for 4½ weeks has been going down, I wonder if the signal is so clear that we should consider a sharp and substantial tax increase of the kind that you suggest, Mr. Wallich, and that some of you other gentlemen indicate perhaps we might put into effect. Do you think that these evidences that I have indicated here are so exceptional that we can ignore them?

Mr. WALLICH. I have never known a period, Senator, when all the evidence was all one way.

Senator PROXMIRE. This is a lot of evidence the other way, though.

Mr. WALLICH. One is always torn between these conflicting trends of evidence. Even when the economy is going very strongly one way, there are always leading indicators that seem to fuzz up the picture.

Now, I am impressed by the argument about orders rather than final sales to the Government determining aggregate demand. I think that deserves some weight. I think that the present high-interest rates and even more credit tightening by the banks is bound to have some effect. At the same time, I am impressed by the demand for credit by the banks seems to show no elasticity with respect to the interest rate at all. They moved from 4½ to 5½ percent in their CD's, (certificates of deposit) just like that. The demand of banks for funds was not choked off by a very steep rise in interest rates.

On the unemployment rate, the evidence, I think, can be read both ways. The labor force seems to be very resilient. We have also made very rapid inroads into it. We are at 3.7 percent. Granted that these monthly figures are a little uncertain, we have eaten into the remaining unemployment faster than we thought. These are the arguments on the other side.

Senator PROXMIRE. Both Dr. Gordon and Dr. Wallich have taken the position, and it seems to be widely shared in the economic fraternity, that expenditures cannot be adjusted nearly as quickly as taxes. I am not so sure about that. It seems to me that in World War II, and in the Korean war, we either suspended or sharply reduced construction expenditures. The President, after all, can act in this area without paying any attention to Congress. He can act like that. He can cut off construction expenditures, public works, and so forth, and it has been done. I wonder, under these circumstances, if there aren't some expenditures, like public works, like perhaps roadbuilding, and others, which could not more properly be postponed, at least and could be done on a period of 2 or 3 months at a time, rather than this tax cut which you then have to go through a big process to undo again?

Mr. GORDON. I made passing reference to that, Senator, in my statement, that there are possibilities of doing something with a so-called shelf of public works, either to speed them up, or with more difficulty to slow them down. The opportunities here, in terms of what I fear may be the magnitude of the restraining effort that may be necessary, I don't think are terribly large. My view about expenditures is also, I am afraid, influenced by the reports that come out of the Congress regarding attitudes toward types of public spending that from a broad social point of view, given my own value judgments or prejudices, I think ought to be decided on other grounds than stabilization.

Senator PROXMIRE. Well, I agree with you wholeheartedly on most of the areas—education, and so forth.

Mr. GORDON. Therefore, if we conceivably need a shift of the order of, let us say, $5 billion, in the size of the Government budget on national income account at present levels of gross national product, I would prefer to get most of it, if not 100 percent of it, through tax changes.

And may I, for the record also, in response to your questions to Mr. Wallich, clarify one point about my own position?

I have said that it is my view that we need fiscal restraint for several reasons. In addition, I have no great respect for my own judgment, and, therefore, I made my proposal beyond the suspension of the investment tax credit take the form of passage of standby legislation, not the immediate imposition of an increase in personal income taxes.

Senator PROXMIRE. Your point is not too clear to me at this moment. You say that you don't favor a tax increase right now, but you do favor passage of standby legislation which the President might use later.

Mr. GORDON. I made my proposal before you came in, I believe, in two parts. One, immediate suspension of the investment tax credit, and second, the passage as soon as possible of standby legislation.

Senator PROXMIRE. On the income tax?

Mr. GORDON. On the income tax.

Senator PROXMIRE. But this does not mean that the President should take advantage of it. You would wait and see on that.

Mr. GORDON. In view of some of the kinds of questions you raise and the fact that the President has not yet, through the Council, taken a firm position, I am quite willing to say that my sensibility to potential inflation and future instability may be too strong; but let's get the debate about the kind of package out of the way now, so that if, in 60 days, 90 days, it is then judged that we need it, we are ready to go.

Senator PROXMIRE. Wouldn't you concede, Dr. Wallich, that there are areas of expenditure by the Government, construction areas, that, if there is the will, they can be cut without seriously affecting the educational programs and welfare programs?

Mr. WALLICH. I think on the way down expenditure cuts may be more promising than on the way up. On the way up, I think it is generally agreed there is very little—maybe $1 billion or $2 billion—that could be spent to expand the economy.

Senator PROXMIRE. What do you mean "on the way down" and "on the way up"?

Mr. WALLICH. To reduce expenditures, construction expenditures. That's what I meant to say by "on the way down."

Senator PROXMIRE. I see.

Mr. WALLICH. There may not be a symmetrical situation here. Antirecession measures may not apply quite so strongly as anti-inflation. Yet, it takes a great deal of administrative control to overcome not only the inertia but the natural self-interest of the parties involved in continuing these projects, and it may not be cheap.

Senator PROXMIRE. In the Korean war, as I recall, the President declared a policy of no new starts; in World War II, there was just no construction on public works—period.

Mr. WALLICH. Well, those, I would think, take a long time, Senator.

Senator PROXMIRE. As I understand, Dr. Eckstein—who, you know, is a very competent economist, a real expert in the water resources area—has challenged a great number of these public works, and said that the economic justification is weak indeed, and, under these circumstances, it seems to me we could at least apply a higher benefit-cost ratio, which would stop a lot of construction, and do it pretty quickly.

Mr. WALLICH. Where we talk about new starts on major projects, I think there we are talking about fairly long leadtimes. Now, when you refer to roadbuilding, that is probably something that can be cut from one month to the next, and that is, after all, a number of billions of dollars a year.

Senator PROXMIRE. May I ask you, Dr. Shoup, to give us an estimate of a $5 billion or a $10 billion increase in revenue that would result if you had this $300 credit you talk about, and which you propose, and a cutoff on the tax at the $2,000 level? I think that is a very attractive proposal. You make a very reasonable argument that the very low income people should not be required to sacrifice, because they are already making heavy sacrifices. The tax cuts into the necessities of life, but I am wondering if it would not result in a very high increase in the taxes of those who would be taxed under your proposal, if you had a $300 credit.

Mr. SHOUP. It would, of course, result in a somewhat higher tax rate. I don't have the figures before me to make a precise estimate. But my impression is that the percentage of total personal income tax revenues coming from those with a taxable income of $2,000 or less is not enough to make the rates that would otherwise be put on change by more than about 10 percent. Instead of calling for a 10-percent increase in tax for everyone, we might have to impose an 11- or 12-percent increase on those above $2,000.

Senator PROXMIRE. Then you have a division in the Congress, though, and a division between labor and management; and you have a debate on the equity issue that can delay it.

Mr. SHOUP. I don't think we will escape the debate by proposing to tax everyone, because, right away, there will be protests that this is not fair.

Senator PROXMIRE. Well, the tax cuts we had in the past, and the tax increases we had in the past, by and large, have been neutral. Isn't that true?

Mr. SHOUP. The Revenue Act of 1964 took a long time to be enacted, partly because it included tax-reform proposals. What I am suggesting is not so much tax reform as it is consideration of the basic issue: Shall we ask everyone in the economy to participate in checking inflation, or shall we not? I think that's the question of principle that has to be faced, and cannot just be avoided by using a word like "neutral." It may be that the majority opinion will be that everyone should be asked to participate, though I should hope not.

If, as a matter of principle, it is decided to exclude low-income households from the anti-inflation tax, it should be feasible to arrive at some consensus on what the amount involved should be.

Just as we arrived at a figure for personal exemptions, many years ago, so now, in approaching this whole new area of countercycle policy, we could reach a consensus on a tax credit or an additional personal exemption, to be used with a tax increase for anti-inflation purposes.

Senator PROXMIRE. I just have another question for Dr. Harberger, and I am through.

Although I would hope we can get that exemption back up, incidentally, we had it $1,000 in 1940, and put it down for the war to raise more revenue, and as you know, it is still $600, and grossly inadequate.

Dr. Harberger, I would like to pursue something that the chairman pursued. You talk about the value-added tax as having what you would call horizontal equity. It completely lacks progressivity, doesn't it? Unlike the income tax, there are no exemptions.

Mr. HARBERGER. That is correct.

Senator PROXMIRE. So that the effect would be that a person with a low income would share a proportional amount, but, of course, he would have to eat into his necessities of life to pay it, whereas a person with a higher income would not. It has that inequity that the sales tax has. Isn't that correct?

Mr. HARBERGER. That is correct. However——

Senator PROXMIRE. Well, then, what you would do is the opposite of Dr. Shoup. As compared with the general progressivity of our Federal taxes, you would impose a relatively greater sacrifice on the low income than on those who are better able to pay.

Mr. HARBERGER. That is what I meant earlier, when I mentioned that one should judge the progressivity of the tax structure as a whole, rather than the progressivity of any given individual component of it. We have many regressive and proportional-type components in our total tax structure, and yet at least at the Federal level, the tax structure is reasonably progressive.

Senator PROXMIRE. Well, there is a lot of dispute on that, especially—let me say especially in view of the findings of the Finance Committee that people having incomes of a million dollars a year or over—and there are quite a few of them, surprisingly many in my view—have a rate of tax on the average which is around 20 percent or lower.

Mr. HARBERGER. Let me put loopholes to one side. I have pronounced on those a long time ago.

Senator PROXMIRE. You are putting a lot to one side.

Mr. HARBERGER. It seem to me that what we are talking about here is something that is easy to move up and down, and something where a small change in rates will produce a rather big change in revenues. Large yield changes for small changes in rates means that the effects of the tax are being spread over the entire economy, and you are not throwing all of the burden of adjustment on any one industry or group or class.

Now, in terms of the question on expenditures, which was just brought up, on Government expenditures, if we are talking about something like a $5 billion change, to have the burden of a $5 billion change be borne by those people who are working directly on Government projects—companies and individuals—is a tremendous thing. And you will get much less total suffering if you spread that $5 billion more broadly over the entire society.

Now, you pay a certain price for this. If you introduce something like the value added tax, which is a proportional component of the total system, you can adjust for this by making corresponding changes in, let us say, the personal income tax, raising the exemptions to $1,000, changing the rate structure, cutting in with a somewhat lower rate of personal tax than we have, and having the progression more sharp than we now have it. These adaptations could be made to keep the overall average tax structure just as progressive as, or more progressive than the present one, and still have the value added tax handy for quick and ready movements in fiscal revenue.

Senator PROXMIRE. Very interesting; but can you imagine the debate we would have on something like this, where you have the rates changed on the income tax, and try to balance the inequity that you have in the value added tax? But I think you can make a strong case for that, if we have the time to work it out in the Congress, and I just wonder if with the time that we consume, whether we can really meet an inflationary situation.

Mr. HARBERGER. I am not suggesting this tax as a device to meet the immediate inflationary situation.

Senator PROXMIRE. I see.

Mr. HARBERGER. I am suggesting it as something which could become a permanent part of the structure, and would make the meeting of the situations like the present one a lot easier than it will be to cope with all of the difficult political problems that will have to be faced if it turns out we have to go the income tax route, let us say, this time.

Senator PROXMIRE. Thank you very much, Madam Chairman.

Representative GRIFFITHS. I might say to you both that the value added tax was dismissed pretty summarily last time in Ways and Means.

I do appreciate, as the full committee appreciates, greatly, your appearance here this morning, gentlemen.

You have added no end to the knowledge that we need upon this subject, and we are grateful for your efforts.

I would like to announce that tomorrow the committee will meet again this room, at 10 a.m. and at 2 p.m. If there are no objections, we will include in the record at this point the statement of Harold M. Somers.

I might say that it is a very interesting statement, and could tantalize you somewhat by his remark that the recent excise tax cut and partial restoration "brought to the fore once again the difference of opinion that exist among economists concerning the proper role of sales and excise taxation in the American structure. At the congressional hearings held in 1964, preceding the cut, those favoring commodity taxation were voices crying in the wilderness. All this, in spite of Galbraith's endorsement of the sales tax in 1958, surely one of the most important cultural developments of recent years."

The meeting is adjourned.

(Whereupon, at 12:25 p.m., the committee adjourned until Friday, March 18, 1966, at 10 a.m.)

(Mr. Somers' statement follows:)

PREPARED STATEMENT OF HAROLD M. SOMERS, UCLA

SALES TAXATION AND THE ECONOMIST

The recent excise tax cut and partial restoration brought to the fore once again the differences of opinion that exist among economists concerning the proper role of sales and excise taxation in the American tax structure. At the congressional hearings held in 1964, preceding the cut, those favoring commodity taxation were "voice crying in the wilderness" (Due, 8, p. 286). The same was true at a National Bureau-Brookings Institution conference held shortly before that (1). All this in spite of Galbraith's endorsement of the sales tax in 1958 (9)—surely one of the most important cultural developments of recent years. Economists had previously been assuming for the most part that a sales tax was "bad" and an income tax was "good." Advocacy of a sales tax had been associated with probusiness, high-income groups and opposition to a sales tax with prolabor, moderate- and low-income groups. Galbraith's stand suggests that it may be possible to favor an extension of sales taxation as a supplement to income taxation without falling automatically into either classification.

Opposition to the sales tax stems mainly from a belief that it is "regressive." There are two things wrong with this simple characterization. (1) The implicit reference is to a sales tax with few or no exemptions. This is not applicable to many of the sales taxes that exist in this country today. (2) The measurement of "regressivity" is generally made by comparing sales tax paid with current family income. A rising percentage with larger income represents progessivity, a falling percentage, regressivity. If we are seeking to convey something about tax burden or ability to pay when we use the term "regressive," however, family resources in addition to this year's income should be used as the basis of comparison. This changes the picture considerably.

Significance of the food exemption

It was shown by Donald C. Miller in 1951 that the California sales tax with a food exemption was progressive, with income used as the measure of ability to pay (13). The family income data available at the time were rather sketchy. More recent and more comprehensive data used by Davies for California and other States suggest that something close to proportionality exists (3, 6). The important point is that the horrible "regressivity" generally attributed to the sales tax disappears with a food exemption even if income is used as the sole measure of ability to pay.

Assets in "ability to pay"

The more important development of recent years has been to take account of assets in some way in measuring a taxpayer's "ability to pay." In order to appreciate this it is necessary to recall the purpose of attempts to measure the sales tax burden.

What are we really trying to find when we measure progressivity or regressivity of a sales tax? We are trying to determine how much sales tax is paid in relation to same measure of "ability to pay." Current income or some close variant has generally been used for this purpose. Is this really appropriate?

With a given volume of expenditures to be financed through taxation, if we do not tax one person we must tax another. We have the problem of deciding whether to tax Peter in order to subsidize Paul. It may be that Paul has a low income at the moment. But what if he has large assets? Do we really want to tax Peter, who has a slightly higher current income if, in fact, Paul has large assets and Peter has none? The following table illustrates (and exaggerates) the point:

	Peter	Paul
Income	$3,500	$2,500
Net assets	----------	30,000

We may be sympathetic to Paul because of his low income. The problem we face in devising a tax-expenditure structure, however, is whether to tax Peter to pay Paul.

Paul's situation is not presented here as being typical of low-income persons. Moreover, for certain urgent policy purposes it may be necessary to use current income alone as the criterion of "poverty" or "nonpoverty," or some other condition. When we are merely measuring tax burden, however, or are framing long-run policy we are not in a great hurry and can take account of any major relevant factors. And variations in assets have been shown to be relevant. Lampman (10, p. 133), using data compiled by Goldsmith, has shown that the assets-income ratio of those with money income (1949) before taxes under $1,000 was 10.8 while in the next higher class it was 3.1 and the average for all classes was 3.6. T. W. Schultz has pointed out that many farmers have very low income but high assets relatively (14, p. 519 n.). One of the practical problems is whether to tax a city slicker with a slightly higher income and low assets in order to subsidize a low-income and high-asset farmer. Yet that is precisely what we are doing if we structure the measurement of tax burden and any resulting tax-subsidy policy in relation to current income only.

It is not really surprising that current income is not closely correlated with net assets, especially at the lower extremity of the income scale. Some low-income people are "between jobs" or have had a poor year and have high assets resulting from previously high incomes. Some people are retired and have very low income but much equity in pension funds or property. They are numerous enough to have a significant effect on the statistical results.

Senior citizens with low incomes may appear to warrant special consideration. The aged cling to their assets, especially large homesteads and are most reluctant to liquidate them to meet current expenses or bolster their current income (2). No one will question their right to do so. One of the issues we are faced with in practice, however, is whether those aged who have a slightly higher income should be asked to support (through the tax system) the low-income, high-asset aged who choose to cling to their assets. We must keep in mind that payments to the subsidized group come from the tax-paying group, unless deficit-financing is used. Since the criterion of Federal income taxation is largely current income alone without allowance for assets or the lack of them, we are in the position of taxing some who are asset-poor in order to subsidize those who are asset-rich (relatively) but income-poor. A man has the right to make the voluntary decision not to use up his assets but does he have the right to require others to support him while he preserves his assets? Can we ignore assets in measuring the burden of taxation?

Broadening of the base beyond the current year's income for purposes of measuring tax burden is suggested by these questions. If a consumer can resort to his assets and his credit standing to bolster his consumption, then his "ability" to sustain his consumption and pay sales tax is not measured adequately by his current income. His net assets are available to him if he wants to use them and his income plus assets measures his ability to maintain his consumption and pay sales taxes even if he chooses to cling to his assets instead. Income and assets combined is also a pretty good indicator of his ability to finance current consumption through the use of credit.

We are getting a false picture of the burden if we confine ourselves to current income and ignore assets completely. But how to take account of assets? Numerous possibilities exist. Among them are: (1) adding imputed income of owner-occupied dwellings; (2) using consumption as the base, which involves including any net liquidation of assets and any credit-financed consumption; (3) amortizing the assets over the life of the owner and adding the current year's amortization to current income; (4) simply adding all net assets to current income as this year's base for tax burden analysis; (5) using "permanent income" as the base.

A few studies have taken account of economic resources in addition to current income in the specific task of estimating the burden of sales taxes. Davies includes net capital liquidations in his base. He thus obtains "disposable receipts" and takes the ratio of sales tax paid to "disposable receipts" in deciding on regressivity or progressivity (3). He has also tried "permanent income" as a base (4, 5). Launie adds all net assets to current income, deriving "net resources" as the base (11).

The use of all assets in the burden measure of the current year is not so drastic as it seems. Many of the low-income families are only temporarily at low income. For instance, many drop from the poverty statistics if a 3-year period is used instead of 1 year. (2). Those with a chronic low-income problem may have a low-asset condition as well; hence the measure of burden will not be affected relatively by the inclusion of their assets anyway. It is true that those with chronically low income and high assets which will have to do them for many years will have their ability to pay exaggerated by the inclusion of all assets in the current year's measure of "ability to pay." In the total picture, the addition of all net assets to current income overstates the current year's ability to pay and this overstatement must be kept in mind in interpreting the resulting estimates of sales tax burden. The inclusion of assets changes the burden picture drastically, however, and even a liberal allowance for those chronically poor whose assets have to be amortized over a period of years (rather than being considered to be available for the current year) will not change the qualitative results or the conclusions drawn.

The ability-to-pay base that is used for purposes of estimating burden should not be confused with the legal tax base used in tax collection. The latter consists of the taxable commodities, e.g., sales of tangible personal property minus exemptions and exclusions. The former represents the economist's decision on the appropriate indicator of ability to pay the tax, e.g., current income, disposable receipts, permanent income, etc. There is no suggestion of changing the legal sales tax base involved in considering one ability-to-pay measure or another. (See Davies, 6, pp. 412–413). We are only trying to find out how burdensome the sales tax really is.

The result of the studies by Davies (4) and Launie (11) is that the inclusion of assets in one form or another shows the sales tax with a food exemption to be progressive. A word must be said, however, about the computations invloved.

The "gressivity index"

Before we can measure regressively or progressivity of a tax as a whole there is an "index-number" problem to solve. The relationship is seldom uniform throughout the entire range of incomes. The percentage may rise for some income classes and fall for others; there may be both progressivity and regressivity. How to arrive at a single characterization of the entire tax? Perhaps the answer is that we should not attempt a single characterization. This is difficult to comply with when the world wants to know whether the sales tax is or is not regressive.

The single measure, however computed, may be called the gressivity index, a neutral term which covers all three cases: progressivity, regressivity, and nongressivity (or proportionality).

Some form of rank correlation yielding a single correlation coefficient is a possibility. Davies has attempted this (5) by correlating (a) ratio of tax base to income with (b) income class. Launie (11) has pointed out that this does not take adequate account of relative degrees of change and has suggested a single progressivity-regressivity index consisting of the ratio of burden of tax on incomes, or other base, above the median income and below the median income. If this single progressivity-regressivity index is 1.0, the tax may be taken as "proportional overall even though variations may exist from one income class to another. If the index is greater than 1.0 the tax is progressive in the sense that the total income above the median bears a larger percentage of tax per family income (or other base) than below the median.

Davies has also used elasticity of the tax base with respect to income as the single gressivity measure (4). If the elasticity of the tax base (e.g., all consumption minus home-consumed food) with respect to income (e.g., gross income) is less than unity, the percentage change in sales tax is less than the percentage change in income and the sales tax structure as whole is labeled "regressive." This certainly solves the problem of getting a single index to represent the gressivity of the tax as a whole, regardless of variations between particular income classes. Davies uses various concepts of income as his measure of ability to pay: gross money income, net money income (gross income minus personal taxes), the Irving Fisher (consumption) measure of real income, and the Friedman type of permanent income. Other concepts of ability to pay are quite possible in using the elasticity coefficient as the single gressivity index.

Since income alone has so long been associated with the measurement of "ability to pay," we use the term "taxable capacity" rather than "ability to pay" to represent all forms of measurement of ability to pay of an individual or family.

By way of illustration, we apply this terminology to Davies' elasticity measure. Leaving unrestricted the measure of taxable capacity (e.g. income, wealth), we have:

G=Gressivity Index=Elasticity of Tax Base with respect to Taxable Capacity of the individual or family.

Progressivity exists when $G>1$, i.e. when the percentage change in sales tax paid is greater than the percentage change in taxable capacity.

Regressivity exists when $G<1$, i.e. when the percentage change in sales tax paid is less than the percentage change in taxable capacity.

Nongressivity (or proportionality) exists when $G=1$, i.e. when the percentage change in sales tax paid equals the percentage change in taxable capacity.

Many other single measures may be devised in such a way that $G=1$ represents nongressively, $G>1$ represents progressivity and $G<1$, repressivity. (If correlation of tax paid by taxable capacity groupings is used, $r=+1$ represents perfect progressivity, $r=-1$ perfect regressivity and $r=0$ perfect proportionality. This could be converted to a scale whereby $G=1$ represents perfect proportionality, etc.)

Gressivity of the sales tax

Using a single gressivity index and employing current income as the measure of taxable capacity, a sales tax with food exemption is found to be slightly regressive. With Ohio data and an elasticity measure, $G=.815$ for gross income and $G=.843$ for net income (Davies, 4, p. 991). With California data and an above-and-below-the-median measure, $G=.931$ for net income (Launie in 17, p. 41).

When we introduce elements of past or expected future income (e.g. use of past saving or borrowing against future income) in the measure of taxable capacity we find that the sales tax with food exemption is progressive, G=1.214 for Fisher income and G=1.198 for permanent income (4, p. 991); G=1.202 for disposal receipts and G=1.359 for net resources (17, pp. 44, 46).

(Note that the amount of excess of G over unity is not comparable from one study to another since the definitions and methods of computation differ.)

Significance of incidence

The argument over regressivity is affected by the conclusions we may draw as to incidence. In empirical studies of regressivity it is assumed that the entire tax payable by consumers is borne by consumers. Portions payable by business (e.g., typewriter ribbons used in the office) are also assumed to be shifted to consumers. The burden by income classes is then determined according to taxable consumer expenditures in the former case and all consumer expenditures in the latter case.

The assumption that the entire tax is shifted to the consumer is in accordance with prevailing thinking (Due, 7). The assumption of 100 percent shifting to consumers appears much too stringent, however, in light of current economic theory. Where departures from perfect competition exist, the conventional analysis in terms of marginal revenue and marginal cost leads to the conclusion that part of the tax is shifted forward and part is absorbed. This is on the assumption of profit maximization. If we entertain other behavioral assumptions, such as Baumol's sales maximization subject to a profit constraint, even zero forward shifting is possible. This occurs where the company is operating within the profit constraint, and absorption of the tax does not push it outside the constraint. In that case, no change in price-cum-tax is called for (15). If a firm always operates at the profit constraint, shifting may occur. If we use Williamson's even broader concept of managerial behavior (20), we get similar results. Where maximization of accounting profit is not the controlling motivation, a tax which reduces profit may not provoke a price increase at all. This is not suggested here as the general, or even preponderant, case but merely as illustrative of the fact that a working assumption less stringent than 100 percent shifting to consumers is probably more realistic than that of 100 percent shifting.

If the shifting is actually less than 100 percent to the consumer, the prevaling assumption of 100 percent shifting to the consumer tends to introduce a bias in favor of regressivity. To the extent that the tax is not shifted, it may rest on the owners of business. Since business owners as a whole are at a higher income level than consumers as a whole, any resting of the tax on business owners would reduce the regressivity of the tax (or increase the progressivity, if such were found). The assumption of complete shifting is particularly aggravating (i.e., it aggravates the regressivity) since the business-paid portion (typewriter ribbons, etc.) is distributed to consumers statistically as if there were no exemptions. Any departure from 100 percent shifting to consumers thus tends to reduce significantly the appearance of regressivity (17).

Absorption of part of the tax by business owners represents a shift to one of the factors of production. This is not the same as assuming that the entire tax is borne by factors of production, a result which requires the assumption of highly competitive conditions throughout. If all factors did bear the tax, however, it would presumably be in proportion to their factor shares; whereas consumers, if they bear the entire tax, do so in proportion to their nonexempt expenditures (plus the adjustment for business purchases mentioned above). Estimates of regressivity would distribute the burden of sales tax revenues strictly by income, whether spent or not and whether spent on exempt goods or not. There would be a strengthening of the appearance of regressivity by virtue of the fact that the exempt portion of consumer expenditures would be assumed to bear its portion of tax; and a strengthening of the appearance of progressivity in that saved income would be assumed to bear its share of tax. The net effect would be strict proportionality at some percentage less than the sales tax rate (e.g., a 5-percent sales tax might represent a 2-percent tax on factor shares).

Relation to income tax

The sales tax has much to offer as a supplement to the income tax. It is not proposed here as a substitute for the income tax. A tax on sales insures some contribution to Government services from those who somehow manage, legitimately or illegitimately, to have little or no taxable income. A general Federal sales tax would also mitigate the prevailing problems in enforcement of State use taxes (16). Nor need such a tax supplant existing State sales taxes; it could act as an umbrella for prevailing taxes, providing immediate credit (much like the unemployment insurance tax) for State tax paid and there would be no net Federal tax payable if the State tax were high enough (18).

Taking account of resources other than current income affects the statistical results in computing the burden of any taxes, not only sales taxes. If comparison with permanent income makes sales taxes appear more progressive, it also makes income taxes appear more progressive (Davies, 3, p. 412).

As usual, however, there are two separate questions: (1) Is the sales tax regressive? (2) is the income tax more progressive than the sales tax? With respect to question (2), there is no doubt that existing sales taxes are less progressive than existing income taxes, however regressivity is measured. This is not in dispute. Since other considerations have induced the use of sales taxes (e.g., revenue needs of States and localities), we are concerned with question (1), i.e., whether sales taxes are in themselves tolerable, the test of tolerability being whether or not they are regressive, regardless of how they compare on that point with other taxes. If they are "regressive," they are beyond the pale in the thinking of many; if they are not "regressive" they are at least acceptable as topics of discussion in polite society. Our contention is merely that many exising State sales taxes are not regressive; we do not claim that they are all more progressive than existing State income taxes. Sales taxes are within the pale and may be considered for some advantages that they have and that other taxes do not.

Although it was conceded above that existing State income taxes are more progressive than existing sales taxes, however regressivity is measured, that need not always be so. Some city payroll taxes without exemptions are certainly more regressive than sales taxes with food exemption. We could also devise graduated sales taxes requiring higher percentages for large purchases. With the known failure of progressivity of the income tax at high levels, it is quite possible that a graduated sales tax would be more progressive than the existing income tax. In some respects we still have "yachts without income." Under a graduated sales tax, owners of the yachts will at least pay a tax when they buy a yacht even if they do not pay a tax on their income (17).

Revenue productivity with exemptions

It is noteworthy that a sales tax can be highly productive of revenue despite large exemptions and exclusions. In California, the following are excluded completely or are exempted from the general sales tax:

Utility services;
Rentals of real property;
Personal and professional services;
Amusements;
Food not consumed on the premises;
Prescription drugs;
Newspapers and periodicals.

Despite these exemptions and exclusions, the sales tax is the main single source of revenue for the State. In fiscal 1965 the sales and use tax yielded $944 million. Individual and corporate income taxes combined yielded $827 million, and all selected sales and gross receipts taxes produced $828 million (19). There is no need to grind the faces of the poor in order to achieve a large yield from a sales tax.

International consequences

A general sales or excise tax should also have great advantages for the United States in the international sphere. Unlike income and profits taxes, an excise tax, under the rules of the international General Agreement on Tariffs and Trade (GATT), can be rebated on exports and a compensatory tax (or border tax) equal to the internal tax can be imposed on imports (see Lindholm, 12). Thus, a general sales or excise tax can be used as an instrument for improving our balance-of-payments positions without violating the rules of the game.

Conclusion

Economic policy makes strange bedfellows. Some groups favor a sales tax because it is regressive; Galbraith favors a sales tax to strengthen public services, even if it is regressive; I favor a sales tax because it can strengthen the Federal tax structure without being regressive. Whether a general Federal saels or excise tax will ever be enacted on one of these assumptions or any combination of them is open to doubt. The voices still fall on deaf ears or none at all. What I wish to point out is that there are actually three voices "crying in the wilderness." The discriminating ear should be able to pick out the one in the right key.

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TAX CHANGES FOR SHORTRUN STABILIZATION

FRIDAY, MARCH 18, 1966

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 recess, in room S-407, the Capitol, Hon. Martha W. Griffiths (chairman of the subcommittee) presiding.

Present: Representative Griffiths; Senator Proxmire.

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

Representative GRIFFITHS. Since I am a compulsive "be on timer," we are going to start.

Mr. Neal, if you would like to present your statement first, and then Mr. Sonne will present his, we will ask the questions afterward.

STATEMENT OF ALFRED C. NEAL, PRESIDENT, COMMITTEE FOR ECONOMIC DEVELOPMENT

Mr. NEAL. Thank you, Madam Chairman. I am delighted to be here and have this opportunity to present some views on behalf of the Committee for Economic Development. I am very sorry that the Chairman of the Committee for Economic Development, who is also the chairman of our fiscal Monetary Policy Committee, could not be here, because he has worked for many years in this field, but he is recovering from an illness.

The subject which you are currently exploring is a most important one, and, as many of you know, has been continuously under study by CED since its founding in 1942. In what follows I propose to discuss the following questions:

1. What role can fiscal policy play as a stabilization instrument?
2. How well do the so-called automatic stabilizers work?
3. How can we best deal with inflation and deep recession?
4. What should be the criteria for the use of discretionary fiscal policy?
5. What are the choices among taxes to be altered?

FISCAL POLICY AS A STABILIZATION DEVICE

The role of fiscal policy in economic stabilization is now reasonably well understood, as the recent symposium of the Joint Economic Committee on the 20th Anniversary of the Employment Act demon-

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strated. The challenge of the future is to improve the mix of fiscal and other measures to level out lesser fluctuations of prices, output, and employment, and to promote growth. Our problem is to use fiscal policy in ways which can complement a flexible monetary policy. Otherwise, the excessive pressure on monetary policy as a stabilization tool may substantially lower the average role of private investment in total demand and keep us from achieving our longer run growth goals.

The main characteristics of a desirable budget policy from the standpoint not only of economic stability but also of economic growth and efficiency are the following:

1. If economic conditions are stable, the budget should not swing from exerting deflationary pressure in one year to exerting inflationary pressure in the next year. This means that the budget should not be an independent unstabilizing force.

2. The inflationary-deflationary impact of the budget should vary with the condition of the economy as a whole, being more expansive when the economy is depressed and more restrictive when the economy is booming or inflationary.

3. If Government expenditures are raised, it should be necessary either to raise taxes or forego tax reductions that could otherwise be made. The budgetary process should present a realistic choice between higher expenditures and lower taxes and call for an explicit decision. This would help avoid a bias toward constantly rising expenditures.

4. The overall impact that the budget exerts upon the economy in conditions of high employment should not, when combined with appropriate monetary and other policies, be so restrictive as to make attainment of high employment ordinarily unlikely or be so expansive as to lead to persistent inflation.

5. So far as consistent with the foregoing, policy should aim for budget surplus to be used for debt retirement under conditions of high employment. This is important primarily because the surplus would add to the funds available for private investment and thereby ease the pressures on monetary policy and so promote economic growth.

As we have said many times, a stabilizing budget policy is achieved when the Government sets its expenditure programs and tax rates so they would yield a constant, moderate surplus under conditions of high employment and price stability. Throughout this statement, the "budget" concept is the national income and product account budget. Such a policy is independent of conditions at any particular time, but it does require attention to the surplus that would result at high employment. The present budget policy of the Government which appears to be in deficit or barely balanced at high employment falls short of the stabilizing budget rule which we have formulated. The high employment surplus—and we now have high employment—should be between $3 and $7 billion.

AUTOMATIC STABILIZERS

Now as to the automatic stabilizers. A policy that would yield a stable budget surplus under conditions of high employment will not actually yield a stable surplus in a fluctuating economy. The surplus will be larger in inflationary booms and, through public-debt reduction, will supply funds for investment and so ease the strain on money and capital markets.

I might add that a good deal of the strain that we now have, including high interest rates, result from this failure on the side of fiscal policy to provide the surplus.

There will be a deficit when economic activity is much below the high employment level, and financing the deficit will use funds not in demand and so sustain income. These swings will occur automatically, as a result of the variations of tax revenues and certain expenditures, such as unemployment compensation, with variations in national income and employment. These automatic swings form a major part of the contribution that the budget can make to economic stability, except in extreme cases of inflation and recession.

The effectiveness of these automatic stabilizers is larger the more sensitive is the tax base to cyclical swings in economic activity. Under these conditions, changing tax yields absorb a large proportion of the variations in national income, and this means smaller variations in income available for private spending.

Unemployment compensation and other transfer payments make changes in income less than changes in employment. Also, income tax receipts change more than incomes. Thus automatic fiscal stabilizers lessen the swings in the national income. As a result, private expenditures fluctuate less than they would otherwise. Thus, automatic stabilizers work by reducing the cumulative acceleration or deterioration in economic conditions that would otherwise take place, and therefore serve to complement other stabilizing forces.

Because the automatic stabilizers depend so heavily on the state of balance in the overall budget, we have urged that Congress adopt procedures to consider the budget as a whole, and to set revenue and expenditure targets in keeping with the stabilizing role that the budget can play.

In making that point, I am aware that the Joint Economic Committee does do this, but the Appropriations and other committees, the Ways and Means, and so on, do not.

DEALING WITH INFLATION AND DEEP RECESSION

Now for a few words about dealing with the things that automatic stabilizers cannot deal with; that is, inflation and deep recessions. Built-in features may not always suffice to avoid inflation or depressions. If further action is needed to deal with these conditions deliberate variation of the balance in the Federal budget, beyond the swings that the automatic stabilizers generate, provides the chief tool that is available.

Experience has demonstrated that changes in Government expenditure are too slow and too uncertain to bring about the desired change. The quickest and most effective method of affecting private spending when change is needed, and with a minimum of carryover into a later period when changes are not needed, is through a temporary change in tax rates.

As this committee only yesterday recommended, it is especially important that a generally accepted method of tax rate change, both up and down, be available for use in a serious recession or in an inflation so that the Government will not be confronted only with the alternatives of doing nothing, or trying to raise or lower expenditures.

To strengthen our ability to use temporary changes in tax rates as a way of stopping the recession and promoting recovery, or holding back excess demand and averting inflation, requires that means be devised for putting the tax change quickly into effect, and for assuring its termination at some point.

There have been recommendations that the President be authorized to propose a temporary tax reduction or tax increase within limits, as to duration and character, specified by previous legislation to take effect unless a concurrent resolution of disapproval is adopted by Congress within 60 days. This procedure could not, of course, be set in motion unless enabling legislation had previously been enacted by the Congress.

We have pointed out that this proposal raises important questions about the distribution of power between the President and the Congress, since under this recommendation inaction or favorable action by one House would permit the President's proposal to go into effect, whereas positive action of disapproval by both Houses would be needed to prevent it.

What is desired is not to tip the balance of power between the President and the Congress but to obtain a prompt decision. An alternative way of doing this would be to provide that the President's proposal to change the tax rates should take effect only if approved, as in the case of ordinary legislation, by a majority of each House, but to amend the congressional rules so that a proposal for a temporary tax reduction, within limits of duration and character specified by previous law, should come up for a vote without amendment in each House within a reasonable period of time—such as 60 days.

It seems to me any reasonable way of doing this is what we are after, and not one specific method. Therefore, I don't want to appear to differ with what this committee has recommended.

The essential condition for use of a temporary tax cut as an anti-recession instrument or a temporary tax increase as an anti-inflation instrument is that the executive, the Congress, and the public at large should understand the functions that such a change would be intended to serve, the circumstances in which it would be appropriate, and the distinction between such a temporary change and basic, permanent revision of the tax structure.

We urged several years ago that discussion then be held and agreements reached—in advance of the kind of emergency that now faces us—among the President and his advisers, the congressional leadership, and the appropriate congressional committees, on the conditions and form of such a tax cut and the procedures by which it might be affected.

To summarize, the need for discretionary changes in the level of tax rates to assist in stabilizing the economy is conditioned by (1) the stabilizing character of the budget, the balance between expenditures and taxes, (2) the strength of the automatic stabilizers, (3) the stabilizing capacities of the flexible monetary policy, and (4) the balance of other forces in the economy, especially wage-price pressures.

To answer the first question directly, the economic case for ups and downs in taxes depends upon the stabilizing character of the budget itself and the uses to which monetary policy is directed. If the budget policy is itself a stabilizing one, if the automatic stabilizers are allowed to exert their influence, and if monetary policy is used effectively, discretionary change in tax rates will be needed only in times of unforeseen emergencies which are clearly distinguishable from the normal and usual fluctuations in the economy.

What we are suggesting is that rather than have a destabilizing budget and plan to freely use discretionary fiscal policy stabilization actions—ups and downs in tax rates—better public policy would be to develop a stabilizing budget policy—a budget policy which produces a moderate surplus at high employment—and rely primarily upon its built-in flexibility and the flexibility of monetary policy to carry the economy through minor fluctuations in income, output and employment.

With such a budget policy it would be only when fluctuations become more serious that discretionary fiscal policies would be necessary.

I think what I am describing here as a desirable policy is the policy which has been pursued up to this point, by several successive administrations.

CRITERIA FOR USE OF DISCRETIONARY FISCAL POLICY

It is clear from the foregoing that we would use a discretionary fiscal policy only in severe and prolonged depressions or when inflationary forces were uncontained. When it is thought that discretionary fiscal policy is needed, the criteria for such action would seem to be as follows:

1. Since any tax change has as its purpose the expansion or curtailment of private expenditures, focus of the attention should not be on the size of the tax change itself but on the effect of the tax change on private spending.
2. The change should be easy to make without creating uncertainty in the administration of or compliance with the tax laws.
3. The changes must be promptly effective and easily reversible.
4. The change must create no uncertainty—well, a minimum of uncertainty—in business planning, investment, and outlay.
5. Any stabilizing discretionary policy should be simple and general, and should leave the tax structure as unchanged as possible.

This brings us, then, to the question: Which taxes would meet these criteria?

THE CHOICE AMONG TAXES TO BE ALTERED

The personal income tax ranks high in satisfying these criteria with cyclical varying of rates preferable to varying personal exemptions. Upward and downward changes of individual tax rates, for example, by an equal number of points or an equal percentage, would meet these standards.

The personal income tax is not a major factor in business planning; it is broadly based; and the rate can be easily varied and changes can take effect promptly through withholding. Variation in personal exemptions might create uncertainty from year to year for many taxpayers about whether they needed to file.

Excise taxes can be easily raised or lowered but, as is well known, there their initial effect on demand is perverse.

Advance notice of changes must be given. Therefore, if rates are to be raised because demand is excessive, taxpayers are put on notice that their purchases will shortly cost them more. This encourages them to speed up purchases and increases demand. Similarly, if demand is deficient, a coming reduction in excise tax rates can lead to the postponement of purchases, further weakening demand. This perverse effect on demand would not be significant for all excises; for example, those on some of the nondurable goods and services—gasoline, admissions, telephone service. But for a large group of other taxed commodities, such as liquor, tobacco, and the durable goods, it might be substantial. Furthermore, increases in excise taxes, once imposed, would result in price changes because of the increase in cost, which in turn might lead to increased wage demands. If the rate change were small, these efforts would also be small, but so would the change in tax revenues. Unless the excise tax were broad based, changes would have to be large and the adverse effects would be large.

Temporary changes in social security contributions have some of the same advantages as changes in the starting rate of personal income tax, but the employer contribution is a cost item, and changes in it may disturb cost and prices.

Furthermore, countercyclical variations in contributions may not be readily compatible with the nature of the old-age insurance system. The Government tries to maintain a schedule of contributions rates that matches actuarial estimates of costs in the long run.

Also, the unemployment compensation system is State administered, and might not be readily subject to variation. The Federal payroll tax for unemployment compensation might be varied with excess collections going into a Federal fund to provide emergency relief in recessions. Shifts in the tax would, nevertheless, still affect costs.

Countercyclical adjustments in the corporation income tax rate, the remaining important tax to be considered, would almost surely create the most uncertainty for business.

This holds for changes in the tax rate, as well as for changes in depreciation allowances, or in investment credits. In addition, the fact that corporate profits respond sharply to swings in economic activity means that changes in corporate tax payments form a large part of the built-in flexibility that we already have in the tax system.

With the build-in flexibility having such a large effect on the level of expenditures in the corporate sector, the need for further discretionary controls over these expenditures would be small.

And now I want to come to the matter of a new tax. We have been working on this subject for more than 3 years, and we hope by the end of this month to have a statement finished on it, and what I am saying is in keeping with what we expect to come out with.

A NEW VALUE-ADDED TAX

The CED has strong feelings about the appropriate direction in which the Federal tax structure should be moving in the longer run. We feel strongly that any new or temporary tax ought to fit sensibly into a longer run strategy for the tax structure.

That is, we should set a goal for our longer run tax structure, and make changes at the moment in response to our current needs in terms of that long run plan.

We believe that a sound Federal fiscal policy for the future should place more emphasis than our present policy does on measures to foster the growth in our capacity to produce.

The chief tax obstacle to capacity expansions has been the corporate income tax. We have suggested on numerous occasions revisions in the tax structure that would increase productivity by stimulating investment.

We have suggested that there is a role in the Federal tax system for a broad based, low rate, general business receipts tax as a partial substitute for the corporate income tax.

Such a tax would add to the flexibility of the tax system by providing a means to raise substantial additional amounts of revenue with minimum adverse effect on incentives or on income distribution. In present circumstances, such a tax could be used, within limits, in place of reimposition of discriminatory excise taxes, or an increase in the corporate income tax, or an increase in the personal income tax.

As the need for revenues subsides, this tax could be retained as a substitute for a part of the corporate income tax. I should like to remind you that the corporate income tax was raised at the time of the Korean war, as a temporary measure, and that temporary increase has never been rescinded. It is not illogical to suggest that if a new tax such as this is added, that the increase in the corporate income tax then, which was a temporary raise for another wartime situation, should be reduced to where it was before that wartime situation developed.

SUMMARY

To summarize my comments, the need for ups and downs in tax rates as a part of countercyclical fiscal policy is conditioned by the existence of the built-in flexibility of the tax system, and the effectiveness of monetary policy as a stabilization tool.

A stabilizing budget policy, a moderate surplus at high employment, together with the built-in stabilizers and a flexible monetary policy, seem adequate to deal with mild recessions and inflations.

For deeper recessions or stronger inflations, however, discretionary fiscal policy is appropriate and necessary. Here we make two suggestions. First, within the existing tax structure, the personal income tax would seem to be the most effective tax to alter to affect expenditures as necessary.

But our alternatives should not be limited to the existing tax structure. Our present tax structure is in need of revision in the long run. In an uncertain world a good tax system should be capable of raising additional revenue, if needed, without serious adverse effects, and should permit a choice among ways of raising additional revenue, with different effects.

Our tax system does not meet this requirement now.

This is basically the bases of the taxes are too narrow, so that substantial revenue cannot be raised without very high rates, and serious discrimination between the taxed and the untaxed.

A value-added tax, because of its broad base, would yield more than $4 billion for each 1 percent of tax. A very small change, which would not materially affect incentives to work or to invest, and would have little price effect, would nevertheless yield a very large revenue.

Establishment of a broad-based, business-receipts tax would not only yield revenue immediately but would also increase the range, versatility, and flexibility of the tax instruments available to the Federal Government if more revenue should be needed.

Thus the value-added tax could be an integral part of our longer run tax structure and can also be used to raise any temporary revenue we may need at the moment. Our second suggestion, therefore, is that a value-added tax be given serious consideration as a permanent component of our tax system as a partial substitute for the corporate income tax. If it is found to be as useful a tax as we think, it can be instituted to meet the temporarily increased needs for revenue and it could be kept in place and the corporate income tax reduced when revenue needs subside. This procedure would permit the corporate income tax to be reduced and the tax structure to be made more favorable for growth at a later time when the stabilizing budget rule permits a tax reduction.

Thank you very much.

Representative GRIFFITHS. Thank you very much.

Mr. Sonne?

STATEMENT OF H. CHRISTIAN SONNE, CHAIRMAN OF THE BOARD OF TRUSTEES OF THE NATIONAL PLANNING ASSOCIATION

Mr. SONNE. I have been very interested to hear what was said on the subject. It can be looked upon from various angles, and my observations are not so very far apart from my predecessors here, and I start by saying that fiscal policy can make a valuable temporary contribution to economic stability, mainly by gaining sufficient time to put our stabilizing forces into play by means of Federal monetary policy, Government programs, and long-range tax legislation.

Such long-term measures should be by far the more important contributions toward attainment of sustainable long-term economic growth compatible with desirable price stability.

Fluctuations in a human society can never be entirely avoided—be it because of errors of economic judgment or because of other factors, such as arms requirements or reductions, world instability and political tension, or unforeseen catastrophes.

Under such conditions, long-range programs are likely to need revision with due regard to the new circumstances. This calls for the careful analysis of the impact on the economy of such new developments, a proceeding which, if done in a responsible manner, may take considerable time.

Pending such new long-range programs, it is highly desirable to avoid temporary fluctuations in the economy of such a drastic nature that restoration of long-term stability becomes still more difficult.

This is the reason why we of the National Planning Association on general principle have favored that efforts be made to make some additions to the automatic, longrun stability that now exists in our fiscal structure.

We had in mind some deliberately designed short-run tax provisions that could be used in case of need—perhaps in conjunction with other measures such as, for instance, monetary policy.

The National Planning Association has recommended this quite recently in a joint statement of February 20, written on the occasion of the 20th anniversary of the Employment Act, in which, amongst other things, we stated:

> In spite of the adoption of policies promoting sustained economic growth, the possibility of recession or inflation exists. Therefore, the Government should be prepared to act promptly if a recession or inflation occurs. For such preparedness it would be desirable if Congress adopted in advance legislation directing a tax change without effective date, which, in case of need, could be made effective, etc.

Some 5 years ago—the idea of such "discretionary fiscal measures" was taken up by the commission on money and credit as a recommendation of which I, personally, fully approved.

However, we can go back much further to show that this part of flexible fiscal policy is not just a passing fancy.

On September 23, 1949, I appeared at a hearing before another subcommittee of the Joint Economic Committee on this very subject, together with two economists.

We had attended a 3-day Princeton meeting, organized under the auspices of the National Planning Association. The 14 to 16 prominent, leading economists who attended had been carefully picked as representing practically all shades of opinion.

The meeting, which confined itself to the study of fiscal policy, prepared a statement entitled, "Federal Expenditures and Revenue Policy for Economic Stability," which we presented to this earlier subcommittee.

It was an outstanding document, not only on account of its contents, but more particularly because all the members of the Princeton group signed it after having reached unanimous agreement.

Don't say that some economists can't agree, now and again.

The document contains, as far as I am aware, the first short and concise explanation of the records and past American experience in the fiscal field and the compelling conclusions which led us away from the old-fashioned idea of a yearly balanced budget to anticyclical budgets and beyond the resulting automatic flexibility to the subject which we are discussing today.

This idea has stood the test of time—based as it was on sound arguments—and since then I know nothing fundamentally new on the subject.

In facing a decision on carrying this idea into practice, it is well to recall the development and arguments which have led up to it. In so doing, several of the questions asked by this subcommitte become less difficult to answer.

Hence, I present the following high spots of the arguments in favor of short-run stabilizing tax changes.

Although our economic system accords an important role to private enterprise, Government expenditures and receipts have now reached a scale that make them crucially important factors in our national welfare.

In 1965 with a gross national product of $676 billion, the Federal Government was spending more than $123 billion while Federal, State, and local government together spent around $185 billion; that is, over 27 percent of the gross national product.

Taken by themselves, tax collections tend to shrink the market of private business, to reduce employment and lower prices; while taken by themselves, Government expenditures tend to expand business activities or raise prices.

It is important that the programs of Government, in their formulation and execution, be consistent with the progress and stability of the private economy.

The traditional goal of fiscal policy in the past was to secure a balanced budget in every single year. But that objective has proved impracticable, for if the budget were balanced in good years as well as bad, there would have to be either big fluctuations in expenditure programs or severe and perverse changes in tax rates. Government would be increasing its employment of resources when they were scarce and cutting down on their use when they were abundant, thus aggravating the fluctuations in private business.

If, however, expenditures were divorced entirely from the need for taxation, the scale of activities of the public sector would grow beyond what was really desired by the people, and sooner or later, the country would find itself in a state of chronic inflation.

Added to this, experience has shown that business activity over the years has its ups and downs. This provides a strong case for countercyclical fiscal action; namely, surpluses in good times and deficits in bad.

If such a policy were not adopted deliberately, we would in all likelihood, have been forced into an imperfect version of it through the pressure of events.

But such a policy was not to be used as an excuse to introduce expenditures and tax programs that could not be justified by their merits, nor was it considered practical or desirable to ignore other measures, such a monetary policy, and to rely exclusively on fiscal action to offset fluctuations to private business.

We could reasonably expect that the budget would be formulated in the light of economic judgment available at the time. If as a result there was not clear-cut reason to expect a change in any particular direction, the objective of policy should be to adapt the budget to changes in the Government's requirements, but to leave its economic impact on total employment and purchasing power unchanged.

However, if recent events and the outlook for the near future pointed, on balance, toward unemployment and deflation, in the private sector, then budgetary changes should be made in the direction of producing a moderately expansionary effect.

On the other hand, if the weight of the evidence appeared to be on the inflationary side, the opposite policy should be followed. Tax reductions that would normally be appropriate should be deferred and tax increases should anticipate increases in expenditures.

Where there is a definite expectation, justified by events, of serious recession or inflation, more strenuous fiscal measures should be called for. Much skill is required to move from depression to stable prosperity. We should not rely on the private economy, unaided by Government action, to perform the task.

Such a Government effort to maintain stability is already aided by the fact that part of our existing tax system consists of measures that provide what are called automatic, or built-in stabilizers, which are important for the following reasons:

With a given tax and expenditure structure, changes in total output and income result in automatic changes in tax yields and in certain outlays, the first changing in the same direction as income and the latter in the opposite direction.

For example: as personal income falls, the yield of the personal income tax falls along with them, while payments for unemployment compensation rise. When conditions are in the opposite direction, you find the same thing occurring.

Consequently, the absolute decline in income available for personal spending is less than the absolute decline in national income. As personal income increases, tax yields rise, and unemployment compensation payments decline.

These and other similar cushioning effects on fluctuations in the amount of income available to the private sector of the economy occur without legislative or administrative changes in tax and expenditure programs and therefore are called automatic stabilizers.

Generally speaking, the higher the tax rate, the more will changing tax yields absorb variations in the spendable income of the private sector. Much depends, also, on the kind of taxes that are involved.

It is difficult to estimate precisely the effectiveness of existing automatic stabilizers. The best available evidence indicates that in recent years the built-up flexibility of the Federal budget offset approximately 35 percent of the variations in the gross national product. That shows that these stabilizers have a considerable influence, far greater than that prevailing before World War II.

This raises the question whether and to what extent we can and should add deliberately made stabilizers to those already existing so that, when combined, they may be able to play a still greater and more effective role in reducing the ill-effects of cyclical fluctuations.

This is the subject before us today, which the statement of the Princeton meeting in September 1949 clearly defined along the following lines:

> The enactment by Congress of rules under which tax rates (and perhaps expenditure programs) will shift in certain contingencies specified in advance is a possibility that deserves further exploration. * * * This raises difficult issues of political principle and administration responsibility.

So we were at this point some 15 years ago.

During the more than 15 years since that subject was drawn to the attention of Congress, the arguments then presented seem to have stood the test of time. The political difficulties then alluded to seem to be less serious if a way has been found of dealing with "tax changes which could be enacted in response to a recognized need, et cetera," as indicated in the official announcement of these hearings.

I would visualize a well-conceived, prearranged, short and concise draft of a temporary tax bill, recommended by either the President or the Joint Economic Committee, which could be adopted quickly, when it was felt necessary, by joint resolution of Congress.

The main point is to find a way of solving a political issue, which undoubtedly can be accomplished through cooperation between the Congress and the White House.

In presenting the high spots of the statements signed by 16 economists and submitted to a congressional subcommittee in 1949, several of the questions raised by this subcommittee have, I believe, been dealt with and answered in part.

Nevertheless, I would like to discuss these topics briefly.

(1) Tax change may be needed very promptly to avoid unnecessary fluctuation during the period that elapses before more carefully considered legislation can be enacted that would be designed to cope efficiently with the specific problems that are faced at the time.

(2) It follows that such tax changes should be of a temporary nature—easy to understand by all and easy to administer both in the initial and closing stage.

The general long-term tax structure has been and should continue to be designed with due regard also then to the fair distribution of the share of the tax burden between the various classes of taxpayers. It follows—in my personal opinion—that these temporary changes in taxes—whether increases or decreases—should definitely be designed to be as neutral as possible, if there is such a thing as a neutral tax.

More particularly there should be a strict separation of temporary anticyclical tax changes and tax reform.

Putting it in another way: It is important to again have a clear separation of shortrun cyclical tax changes from longrun structural changes in our tax system. The latter requires much more careful and longer deliberations than contemplated under this program.

While increases in taxes may be needed when inflation is feared and decrease is visualized if the reverse is expected, there is apt to be uncertainty as perhaps there is today, about the degree of the emergency.

This difficulty may be overcome by authorizing maximum changes—up or down—to an extent not exceeding altogether a certain amount or percentage of a certain category of taxes, but carrying these changes out in various stages—for instance, three stages of one-third of the total. This would provide flexibility during a period in which uncertainty still prevailed.

(3) While the National Planning Association has not proposed any detailed plan of procedure, it is my personal opinion that no new types of taxes are needed for this purpose. I believe that the personal income tax lends itself best to counter cyclical variations, and I recommend adjustment in the rates of the first four brackets as most suitable.

In that respect I endorse, in substance and in principle, the recommendation made some 5 years ago by the Commission on Money and Credit which studied the problem thoroughly and carefully weighed and rejected a number of other feasible alternatives both from a technical and practical point of view.

Using rates of the first four brackets—averaging 15½ percent—is least likely to open up controversial questions of tax structure.

The legislative and administrative problems would be relatively simple. The change could be made effective with very short notice to taxpayers through the withholding mechanism and would be easily reversible.

Moreover, small changes in the tax rate of these brackets would provide large amounts and consequently, a decisive impact on the economy.

A 1-percentage-point increase in the tax rate would withdraw from the spendable income of consumers about $1.4 billion.

The average 15½-percent rate applicable to taxpayers on their first $2,000 of income would be increased, or reduced, but all other bracket rates would remain unchanged.

If the four first-bracket rates were increased by 1 percentage point for a full year, the tax variation would work approximately as follows:

Under the present law a person with a taxable income of $4,000 pays 15½-percent (average rate) on the first $2,000 of income (tax liability of $310, namely $70, $75, $80, and $85 on each item of $500) and he pays 19 percent on his next $2,000 of income ($380).

His total tax liability is $690. If a 1-percentage-point addition were effectuated this same taxpayer would have to pay $330 on his first $2,000 of income and would continue to pay 19 percent on his next $2,000. His total tax would be $710 and namely $20 more than before the change.

Authorizing such a change to the extent of, say 4½ percentage points applicable in, say, three installments of 1½ percentage points each, could have a considerable effect, perhaps over $6 billion in total, on the public's ability to spend and might be termed as nearly as possible "neutral" in its effect on the taxpayers.

I hope that this answers the questions posed in connection with the three "topics" chosen by this subcommittee.

Without wishing at this stage to express too rigid an opinion on the details, National Planning Association continues to favor an attempt to fill the need for a design of temporary tax changes as a precautionary measure.

Let me conclude with a few further personal observations.

Such a shortrun tax design cannot necessarily cover all the special needs that may develop at different times.

Today, for instance, there is room for the argument that imbalance may develop between investment, particularly in business plants and equipment, and consumption, which may make it desirable to use a brake on investment before it is used on consumption.

Nonresidential investment in business plant and equipment seems recently to have increased temporarily at a rapid rate, namely from 6.7 percent of gross national product in 1963, 7.1 in 1964, 7.7 in 1965, to a projected percentage of 8.2 in 1966.

While a steady increase is desirable, particularly with a view of becoming more competitive, and in such a way contribute to improve our export and import balance, the present rate of increase may well be too rapid.

Therefore, it is a very useful task, but it may well be that at present rates, the increase is running a little too rapidly. And this could be rectified by suspending for new projects, temporarily, the present 7-percent investment tax, coupled with a definite assurance that such suspension would be terminated as soon as conditions permit, on the ground that it is a very sound tax.

This proposal, designed to take care of a special situation, should not be regarded as a substitute for the proposal previously under discussion for standby tax legislation.

Whereas a temporary reduction in taxes and consequent increase in the capacity for private spending would result in increased activities in the private sector, any surplus that may develop as a result of a temporary increase in taxes would normally be expected to be used to reduce our national debt.

Shortrun stabilizing tax change measures obviously must be based on the assumption that we are convinced of the desirability of "countercyclical fiscal policy"—namely, surpluses in good times and deficit in bad.

Hence the need to clarify the national debt issue, on which an interesting discussion took place in the 1949 subcommittee of the Joint Economic Committee, previously referred to, when a prominent Senator asked:

> Whether the net result this policy would indicate, perhaps, a long-term reduction in the national debt rather than a long-term increase in it—or a long-term balance.

The answers of the representatives of the Princeton group ran along these lines:

> The future course of the national debt will be determined by events—not by the budgetary policies of Government. If we have more depressions in the future than we have booms, we will inevitably have an increase in the national debt. We feel that the policy we recommend here will not result in any greater increase in debt than any other policy that might be adopted.

I think it is interesting to see what people said 15 years ago. The Senator then came along and said:

> What you are saying is that if the purposes—now mainly those of the Employment Act—are successfully effected, then the national debt will be reduced.

I think he wanted to hear that.

But the economist answered:

> You may say if the inherent strength of our economy is sufficiently great the Government may be able to afford to tax more than it spends without impeding prosperity. But we may, in fact, need deficits to attain the objectives of the Employment Act.

He said that in 1949.

Another economist said:

> At the end of, let us say, a 30-year period, our debt will be either increased or reduced. If it is enlarged, it will be regarded as a lesser evil than to have faced large unemployment.

Since this interesting discussion, 16 years have passed, and it is useful to appraise the development since 1949, when our national debt was approximately $257 billion against $321 billion at the end of 1965.

Guaranteed and insured loans—practically all private—had meanwhile increased from approximately $16 billion to approximately $91 billion.

That may seem a large increase in debt, but we must bear in mind that during the 16-year period we were faced with a number of difficulties; first:

The need to complete the transition from war to peace, involving modernization of plants and equipment;

The need to rebuild and modernize our defenses to meet threatening and actual conflict—in fact, two conflicts: Korea and Vietnam;

The large unemployment problem; and

Our determination to assist war-torn and needy foreign nations on an unusually large scale.

It may be too early to form a definite opinion, but, considering all circumstances, our performance has not been too discouraging and there seems, so far, no reason to regret the fiscal policy which we have followed to the exclusion of other alternatives.

If a doctor fears that his patient—as a result of taking apparently healing drugs—may become an addict, it may be a lesser evil to insist on the patient recovering in a slower though more painful way.

There is, therefore, nothing inconsistent in being in favor of anticyclical policy in some stable countries and not recommending the same policy for countries with less stable and levelheaded governments.

Take, for instance, Brazil.

We have, so far, no reason to regret the path which we have chosen.

But we must be consistently and constantly on the alert, and avoid too ambitious plans, in the knowledge that generally there is no end to the demands for improvement, yet a definite limit to the resources available to any nation.

Our international balance of payments constantly reminds us of this fact.

Our economic developments are being followed not only by the eyes of the friendly world but also by those of unfriendly foreign elements who would like nothing better than to see the United States dethroned from world leadership as a result of a devastating inflation which the wrong policy may carry in its wake.

I believe that the success of anticyclical policies depends greatly on the flexible attitude of policymakers, and the general public, coupled with a keen desire to put their shoulders to the wheel.

Having faith that this attitude will prevail, I continue to favor the concept of anticyclical policy for our country, and, as a natural consequence, I am in favor of the concept of shortrun stabilizing tax changes which we are discussing today.

Representative GRIFFITHS. Thank you, Mr. Sonne.

I feel that you have both presented very interesting papers. I would like to ask you, in the light of 16 years' experience, do you feel now that we will ever make a substantial payment on the national debt?

Mr. SONNE. On the national debt. You see, you start right out with one fact—a showing—that you cannot just talk about the domestic field without right away getting into the foreign field.

The two go together. If you had been at the New York World's Fair, you may remember the General Electric exhibit, which showed a beautiful room in front, and you turn around and you see something pretty ugly behind. The two have to go together, and one of the painful things in this country, which is overlooked at the present moment, is our international situation. And, consequently, I feel that now that we have solved the employment problem—or, anyway, come down to a figure which we don't need to be ashamed of—the policies we carry on from now on, also in this particular case, should be weighed very carefully, with due regard to what effect they have on our balance of trade; and we should have that constantly in mind, until we feel that now our international situation is such that we don't need to be ashamed of it.

Representative GRIFFITHS. At the present time, it seems to me—at least in my office—one of the objections that I am receiving most frequently are to rapidly increasing cost of food products.

Would either of you care to comment as to how any type of tax increase could stabilize the cost of food products, and which one would do it fastest?

Mr. SONNE. Yes. I would, but perhaps Mr. Neal would like to comment, too.

Mr. NEAL. Well, I would be very happy to say that the price of food products, which we dealt with in a statement 2 or 3 years ago on farm policy, is itself a considerable reflection on the policies of the Government toward agriculture, as you so well know.

I mean, in order to provide the farmers what is considered to be an adequate return, we have various crop restrictions and other programs designed to hold up the price of agricultural products. So it is not so much a matter of tax change here as change in our agricultural policy; we would spend less, and could reduce taxes more.

But it is basically a matter of our farm policy, which we feel should be moving toward freer markets. We believe that by moving toward freer markets we could have both somewhat lower prices and better incomes for farmers.

Now it is a long story, and as you know, it is a complicated one.

Representative GRIFFITHS. Well, in your judgment, will a tax increase, regardless of how it is done, not affect the price of food?

Mr. NEAL. I think it is not so much a matter of a tax increase as a matter of the state of the budget, as I said in my statement.

If we have an inflationary budget, as we now have, it is bound to affect the price for food products. They are going to go up, along with prices of other things. Whatever is in short supply, relatively, is going to go up, so that if we have a less inflationary budget, I think we can be sure that farm prices will go up less than they otherwise would have gone up.

Representative GRIFFITHS. What would you do to the budget to make it less inflationary?

Mr. NEAL. Well, I think that Mr. Sonne and I have both agreed. We think that a temporary tax increase, in some acceptable way, as has been proposed by the Joint Economic Committee, would be the appropriate medicine right now.

Representative GRIFFITHS. Would you repeal the investment tax credit?

Mr. NEAL. No, I would not. On this, Mr. Sonne and I are in disagreement, and it is friendly, and we can have difference of opinion on this.

But I think this proposal—and I realize that there are a number who are quite favorable to it—falls in the same category as that of attempting to do very much quickly with Federal expenditures. That is to say, by the time you get something working, so many months will have passed that the effect—the main effect—may come just when you don't want it.

The advantage of a tax change is that you get the effect exactly when you want it. You build it into the legislation. You have it happen, as of April 1, or something of that sort. You can't very well do that with changing the investment credit.

You have projects underway right now. They can't be changed. You have projects that are committed that would be exempted. I am sure any legislation would apply to future projects.

Well, those future projects would be, perhaps, 6, 8 or more months away. And then the effect would be gradual.

There are many who think that 6, 8 months from now, the effect of the actions recently taken to increase tax collections and so on, will be much more effective than they are now, so you may get a double effect, which would be bad. But beyond that, I want to make two other points about this investment credit.

Usually, when we have a wartime situation, one of the first things we do, and it is significant that this has not come up now, is to pass legislation to provide rapid amortization for facilities needed for the war. It is very interesting that this time, with an investment credit, and with the existing tax law, we have been able to take up a very great strain of capacity expansion related to war purposes, without any special new legislation.

If we take away the investment credit, we would probably have to put something in its place with respect to war facilities, and we would have to build up a bureaucracy to do this and so we go through the things that we went through in the Korean war and earlier.

Second, I would like to come back to this international position. We are bearing a great cost for the maintenance of peace in the world. Our European allies unfortunately are not.

They are not helping us where we are hurting. They have a tax system lower than ours, and much more conducive to business expansion than ours. So much so, and so attractively so, that one of the reasons we have a balance-of-payments problem is that American businessmen have found it to a considerable extent more attractive to invest in Europe than in the United States. So changing the investment credit is a change in the wrong direction from the standpoint of maintaining American efficiency in competition in world markets, and in making the United States a better place in which to invest than the alternatives that are available.

Mr. Sonne. I would say that your question about how to improve farming is a case now in point, and when I say that these temporary taxes, should be temporary, and come and disappear quickly, it is because you should make room for a real thorough study.

Now, to really work out a tax system that would help agriculture, for instance, is a thing that can't be done in a moment. It takes time. But it is an important subject, and I may say that during these 16 years we have been up against a situation in which one was laughed at when one said, "One day, export of farm products will be a great asset for the United States," and people laughed.

Now, see what has happened. There is no question that the increase in population, and other things, will mean that one day, again, the United States will benefit by being in substance in export of food products, and the same applies, for instance, to the tax that CED talks about.

I am all for that tax, and particularly the one where you substitute part of the corporation tax for value-added tax, and I am for paying that tax for the very reason that my colleague mentions—that the Europeans, in their competition, will reduce or deduct in their costs in exports a number of local taxes.

We can't deduct enough for the present corporation tax, but the one of the CED can, so I am all for the tax, but indeed, I may say, I am so much for the tax that I don't like to make it a temporary one.

In other words, I don't think it should be introduced on this temporary basis.

Representative GRIFFITHS. Isn't an added-value tax chiefly passed on to the customer?

Mr. NEAL. I think that probably most economists would maintain that this type of tax is chiefly passed on to the customer, which is one of the reasons why it is permitted to be rebated on exports, for example.

Representative GRIFFITHS. Well, then, how can you keep it from falling most heavily upon the lowest income group?

Mr. NEAL. Well, the customer is everybody who buys, and the lower income group does not constitute the biggest part of the American buying power.

Representative GRIFFITHS. But there are certain things which they buy of which the richest person can't buy more. Therefore, they are paying, it seems to me, out of all proportion to their income.

Mr. NEAL. The kind of tax I am talking about is a very small tax, as I suggested—you know 1 percent tax would provide $4 billion.

And we have variations in the cost of living almost from month to month of substantially the same magnitude, so that what we have here is not anything very big, so far as the consumer is concerned.

Representative GRIFFITHS. Well, now, if you had an added-value tax, would you then vary it by an act of Congress, and how frequently would you contemplate that it would have to be varied?

Mr. NEAL. I would like to restate something that I said earlier. We are not proposing a value-added tax as a temporary tax.

Representative GRIFFITHS. No; I understand.

Mr. NEAL. We are proposing that a value-added tax be instituted at this time to raise needed revenue, and that it remain a permanent part of the tax system, and that the temporary increase in the corporate income tax made to finance the Korean war be finally, when we get around to it and can afford it, repealed.

Representative GRIFFITHS. Mr. Sonne?

Mr. SONNE. You raise a very interesting question about the value-added tax. When I first heard of it, I was also afraid that it would just be laid on the consumer. But when you really study taxes, bear in mind that the CED have in mind that eventually this value-added tax will remain, and the corporation tax might be reduced.

You see, a corporation tax is also added on to the consumer, and that is the trouble with all taxes, so I frankly don't think that the value-added tax would be worse than a large corporation tax.

And I would say, in a sense, the same thing about this 7-percent investment that if the result of taking it off temporarily would be that it would never come back, I would oppose it. I am merely saying and thinking that under present conditions, which we hope are only temporary, it would not do any harm for 6 months or a year to go a little slow on it, because we are going a little fast on new construction in this country.

Representative GRIFFITHS. Thank you.

Senator Proxmire?

Senator PROXMIRE. I understood you to say, Mr. Neal, that you do favor imposition of a tax increase right away, and I would assume that you don't feel that the Congress would be able to act with sufficient speed on value-added tax to impose that within the next few weeks, so that we could get the kind of immediate effect on price stability that we would get with an increase in, say, the personal income tax.

Is that correct?

Mr. NEAL. Yes; I think that I would be naive not to agree that a brandnew type of tax, virtually unknown in this country, could not be installed very fast, but I think it deserves consideration.

Senator PROXMIRE. I want to get into that deeply in a minute, but you do at any rate, at the moment, favor increasing the personal income tax?

Mr. NEAL. According to our budget rule, an increase in taxes is called for, and according to the analysis we made over a period of years—because we have been considering this, not just now, but over a period of time—our position was that within the existing tax system, variations in the individual income tax is the best choice today.

Senator PROXMIRE. And how big an increase do you propose?

Mr. NEAL. Well, that follows from the budget rule, sir. If we take the lower limit of our budget rule, which says that at high employment—and our high-employment rate has been achieved—that at high employment, we ought to have a surplus of between $4 and $7 billion, this means a turnaround of about $5 billion from where we are now, so we need about $5 billion, by our budget rule.

Senator PROXMIRE. How would you get it? That is my question.

Mr. NEAL. Oh, by a flat, across-the-board-percentage increase in income tax, or by increasing each bracket by an equal number of points.

Senator PROXMIRE. You differ from Mr. Sonne, who would only tax the first four brackets?

Mr. NEAL. Yes; that is the recommendation of the Commission on Money and Credit, but I don't think we feel very strongly on this. This is not a major point of disagreement.

Senator PROXMIRE. Your position is, to my judgment at least, a lot more neutral. You hit everybody, on an equal percentage basis; Mr. Sonne, as I understand it, would hit the low-income people a whale of a lot harder.

It is true that everybody would have to pay, because we all pay in those brackets, but Mr. Sonne's proposal would not hit those whose incomes, at least that part of the income which is not hit in the first four brackets.

Mr. NEAL. I think that the important thing is to get agreement on what is as neutral a basis for doing it as possible, and to do the same thing backward that you do forward. That is to say, if you go up by a percentage, then come down by a percentage.

Senator PROXMIRE. If you ever come down.

Mr. NEAL. If you ever come down; right, sir.

Senator PROXMIRE. You have made that point very well I think, and it is a good point. That is why we have to consider very carefully the equity of what we do temporarily. These temporary measures can be pretty long run.

You know what Keynes said about the long run: "In the long run, we are all dead."

Well, Mr. Neal, I am surprised that you as a CED spokesman have advocated no consideration of spending reductions, say, in the area of construction. In the past we have reduced spending, in a period of economic stability, to attempt to balance the budget.

Isn't there any kind of spending in your judgment that we can promptly cut? After all, this does not take any congressional action. The President can just step right in and refuse to spend the money, even though Congress has appropriated it.

I found to my displeasure that the President had done that in the school milk program last year. He can do that anywhere.

Mr. NEAL. I appreciate your bailing me out of a very serious omission. In concentrating on what could be done fast, and what could be agreed upon, I deliberately understressed the expenditure-reduction possibility. I merely said experience had demonstrated that it did not work fast enough.

That does not mean that I would not be opposed to it. I mean we are in favor of a stabilizing budget rule which calls, now, for a surplus. Obviously, mathematically and so on, you can get this by reducing spending, or raising taxes.

Senator PROXMIRE. Suppose we simply cut roadbuilding sharply—cut 25 percent, or 50 percent. You could do that right away.

Mr. NEAL. I think that the Government should explore every avenue for withholding money appropriated; and as a matter of fact, in another statement, we have recommended that the President's power in this respect be made very, very clear. There is some question of power, as you know, on this.

Senator PROXMIRE. You mentioned a moment ago, as you did in your statement, that you feel we should run a \$4 to \$7 million surplus at the present time. You say we have gone past the high employment target. Are you making an assumption, then, that 3.7 or 3½ percent unemployment is not sustainable in our economy, that we have to accept 3 million people out of work, we have to have 10 percent of our teenagers unemployed, 7 percent of our Negroes out of work?

Don't you feel we have made any progress with our manpower training or can, in the near future?

Mr. NEAL. Senator, those things that you have just recommended that we do for reducing unemployment or raising incomes, we also have recommended. But the judgment at the time we formulated this rule, and based on what we had been able to do in the past—as I said, this rule was made in 1962—was that the high employment level—

and we were below it then—would be the 96 percent employment, 4 percent unemployment level.

This was a rule that we had been working on and trying to attain, you remember. We had not been there for quite a while. So that we formulated the rule on that basis.

You can formulate a rule on another basis. You can formulate it on instead of a 96 percent employment level, you can formulate it on a 97 percent employment level, but I assure you what you will get when you do it, under present circumstances, is a requirement for a higher surplus, the higher the employment level.

That is what we are getting right now. As you go to 3.7, you run into bottlenecks and inflationary pressures, excessive wage increases.

Senator PROXMIRE. Well, do you—this is what we have to study carefully. We theorize about this, when we have unemployment of 5 percent, 6 percent, 7 percent. Now we are at the 3.7 level. It seems to me we can observe this; the CED is a very, very highly respected organization. It has great impact on the country and on the Congress. If you gentlemen feel that you will stick by what may be an outdated notion that you can't get unemployment below 4 percent, it can have a very serious impact on a whale of a lot of people.

The most important element in training this manpower is the very fact that it is needed, that business needs it and, therefore, is willing to spend the money and make the investment to bring people into the plant, teach them skills; therefore, there is a real reason for the Congress to press as close to full employment as possible, and to crowd it, and to question constantly whether or not it is true—this theory that we have had before—that, under present circumstances, we can't get below 3.7, or 3.5, without such serious inflationary pressures, and we don't want to pay the price.

Mr. SONNE. Having been in on this, in connection with the Employment Act, from the beginning, I would say that the 4 percent which my colleagues mention seems very sensible. You see, in the beginning, when we really worked at what we were aiming at, we always figured that there would be something called "frictional" unemployment—that is, people changing from one job to another—and already in the beginning of the idea of this we were all clear on this—that 3 percent unemployment was really full employment.

Now what has happened with frictional unemployment in these 20 years is that, fortunately, the unemployed, and the laborer, is better off than he was. When he loses a job, he is not going to take the first one offered; he is going to wait, and can afford to wait until he gets something he likes.

Senator PROXMIRE. Well, if you have an appropriate unemployment compensation system, he takes the job or he loses unemployment payments.

Mr. SONNE. He waits a little longer; and here that is in his favor; therefore, the 3 percent we figured as frictional unemployment 20 years ago may very well be today very close to 4 percent.

I would like to point that out.

Senator PROXMIRE. You gentlemen referred to Europe as the prime example from which we can learn lessons. They have had a lower unemployment than 4 percent or 3 percent or 3½ percent. In Germany, it has been for years, many years, less than that. They have had great economic growth. It is also true in France. This is true in the other European countries.

Why do we have to accept the notion that a much larger proportion of our people must be out of work here?

Mr. NEAL. Senator, that is precisely what I was going to answer in observation in your previous statement. I don't think anybody is happy in accepting a 4 percent unemployment level. We would want to do better, but we would not want to wreck the economy to do it.

Now one of our greatest difficulties in this regard—and I will impose on that kind reference you made to CED to try to urge——

Senator PROXMIRE. No, I meant it. It is a great organization.

Mr. NEAL. To urge something that we have urged, and which is in your hands, sir, and those of your colleagues. And that is a study of unemployment, a current reporting of unemployment in the way that it is done in most of the European countries. That is to say, unemployment as against job openings.

Now the thing we don't have in this country is data on employees available, unemployment, as against job openings. And as you know, most of your European countries are running 100 percent employment or more with their unemployment rates.

The way they measure unemployment, by the way, is different from the way that we measure unemployment. So that our four is comparable to, depending upon the country, as much as half of the rate that you would have there. There has been a special study on this, I think, conducted by the Department of Labor.

So that what I would urge, sir, that to give us more courage about moving off our traditional 96 percent employment rate, we need information on job openings, as against unemployment. And this has been proposed by the administration, and has been turned down by the Congress.

Senator PROXMIRE. Well, let me say, I am chairman of the Statistics Subcommittee of this committee, and we have worked hard to try and get a job vacancy study. We favor it enthusiastically; we recognize that there are shortcomings in our statistics, but when you talk to the statisticians of other countries, they say ours are by far the best; our unemployment statistics are much more comprehensive. About all they have to rely on are reports that they get from their unemployment compensation system, or something of that kind. Ours are based on a far more comprehensive survey.

For us to give up this kind of statistical system that we have—which seems to be more comprehensive, and more accurate, and more reliable than theirs—for their system, which is less adequate in their view, would seem to me to be a step backward.

My time is up.

Representative GRIFFITHS. May I ask, does not the value-added tax make private incomes and spending less stable and Government income more stable?

Mr. SONNE. Did you ask me?

Representative GRIFFITHS. Well, either Mr. Neal or you.

Mr. SONNE. Well, I would say that a value-added tax would be relatively more stable for the Government, and from that angle, a very desirable tax. I mean, from the point of——

Representative GRIFFITHS. But from a private sector, is it such a desirable tax, therefore? Doesn't it make the business cycle become worse?

Mr. SONNE. Yes, but you see, there is always a minimum of consumption. Therefore, the Government can say, well, never mind what happens, there is going to be a minimum expenditure of so much we again can always rely on something. I should think a value-added tax would be less popular with the low-income people; whether low in reality, doesn't mean much, but they would kick themselves anyhow, and think, "We have to pay that additional tax."

Representative GRIFFITHS. Well, wouldn't it require more discretional fiscal power than any other type of tax? Aren't you going to have to operate the discretionary power more frequently?

Wouldn't you say so?

Mr. NEAL. I now appreciate the purpose of your question, Madam Chairman, which is a very good one, and one that we considered very carefully. When we recommended a substitution of a value-added tax for corporate income tax, we said for part of the corporate income tax, partly for the reason that your question indicates, that the corporate income tax absorbs a considerable part of the income fluctuation, so that from a stabilizing point of view, a certain amount of corporate income tax probably is a good thing to have in the tax system.

However, we think we could get enough of that if we had a 38-percent corporate income tax, rather than a 48-percent tax.

Senator PROXMIRE. If the chairman would yield just for a minute—you would get 25 percent less, though.

Mr. NEAL. Yes, but we think that there has been a buildup of the automatic stabilizers over time, that is, the unemployment compensation, and the old-age pensions, the other things that act in the automatic stabilizers, and now the whole poverty program, including the increased expenditure on education, as part of the poverty program, and also as part of the new education program.

With instability in the economy in future, the amount of money that we are going to put into training people and retraining people, and educating them, as a countercyclical thing, is going to be very large, so that while we may take away some of the stabilizing effects of the great variations in corporate profits taxes, we are adding stabilizing effects in the social area, which is probably a better place on the whole to have them.

Representative GRIFFITHS. Now may I ask, Mr. Sonne, why did you choose the first four brackets of the income earners to tax? Politically, this is the most difficult.

Mr. SONNE. They were chosen 5 years ago. Where the first bracket was $2,000.

Representative GRIFFITHS. All right, why did you think that this would be the most effective?

Mr. SONNE. Because that is the most simple thing, and of course, you begin to say, well, who should really pay for this? This is a temporary emergency. We want to keep prices down. And now you say, I want to find the easiest and most practical thing in the world to do.

Representative GRIFFITHS. And this would do it.

Mr. SONNE. But the second is, if you don't do that, then you begin to argue who is it really that is benefiting by this? And one of the first people that are benefiting by keeping prices low are the low-income-rate people. Now I did not like to approach it from that angle, mind you, but I simply say this is something that would last 6 months or a year, until we get some relief, and this is by far the simplest.

Everybody puts a shoulder to the wheel. Immediately, you get up to the higher brackets, then you only have a certain percentage. Then I remember we discussed, if you don't use that, but want something entirely different, then you can say we are in a reasonably bad position, and what does the family, what does Uncle Sam do when he is low economically? He keeps himself and his family at home.

What the United States should do is stop all this waste on tourists. That is an entirely different thing. Don't stop them from going, but put a tax on each person going out and back again—$50 or $100—so as to remind him that, as long as we have not got our house in order, this going out and drinking cocktails, and so forth, is undesirable. Those were the two things we considered, but we came to the conclusion that this would also be a kind of a special thing that ought to be very carefully thought out. But in the first bracket, we have the simplest method.

Representative GRIFFITHS. Well, now, actually, it would be the one that would come the closest to lowering the price of food; wouldn't it?

Mr. SONNE. Yes, it would; but, you see, the whole tax, and the whole measure——

Representative GRIFFITHS. Because you would simply say to the people at the lowest economic level: "You are going to pay taxes in place of eating lettuce."

Mr. SONNE. You see, the whole measure that we are talking about here is one which would contribute to a certain amount of deflation, rather than inflation, and, therefore, if we do it, we can be sure that, at any rate, prices for food will be lower than they would have been if we had not done it.

And, consequently, it is in the brackets that use a very large percentage of their income for food that this is very important. But we don't feel very strongly whether it is the first bracket, or an average like you say. I just want something that is very simple, and that can be dropped very quickly.

Representative GRIFFITHS. You could put a temporary tax on a percentage of tax liabilities, as a quite simple tax?

Mr. SONNE. Oh, yes.

Representative GRIFFITHS. But the point of it is that a tax at the lowest bracket on the face of it, in my opinion, would be very unfair. To say to those at the lowest level: "You will be the people who take the burden of stopping the inflation. While it may help you the most, you are going to be the people who pull the greatest part of the load."

Mr. SONNE. Well, it would be politically wrong——

Representative GRIFFITHS. And in the second place, I think it would be very difficult to do.

Mr. SONNE. But, in reality, we have specifically said that the wealthy people must pay more, relatively more, and that comes into the long-term structure we have. The long-term structure, very definitely, makes the wealthy people pay more than the lower income people. Now you have a temporary situation which I liken more to the simplicity of the Mormons' tax system. We have a temporary situation. We want to raise, and everybody pays a certain percent of his income, until we can see how to distribute the burden.

This is the argument. Because we don't deny that the wealthier people should pay a much larger percentage of their income for taxes. They are doing that in the regular tax budget.

Representative GRIFFITHS. But, of course, part of the argument last year for the reduction at the highest level was that, in actuality, those people are not paying the indicated percentage in taxes, anyhow.

I think very few are paying more than 52 percent, I believe, as was proved before our committee. There was no one paying 90 percent. Nobody was paying 80 percent.

Mr. SONNE. Oh, no; but they certainly are paying more money.

Representative GRIFFITHS. I know of a woman—not a constituent—who lives in Detroit and draws a million dollars from municipals, annually. That is quite a nice income. I don't think she even has to declare. She doesn't even have to face the problem of making out the tax form. [Laughter.]

Mr. SONNE. But I think you may say that the lowest brackets are around about 12 or 14 percent. Normally, there are a lot of people that pay between 50 and 60 percent, but that is even a reasonable distribution.

Representative GRIFFITHS. Politically. Yesterday, as Senator Proxmire pointed out, that it was possible that last year's tax cut was politically a tremendous thing. If you look back at previous tax cuts, you will realize that the now minority party gave two tax cuts, for which they were defeated.

I don't think there is that much political mileage in a tax cut, or a tax increase. I personally question that there is any real, dire danger in a tax increase, but I think that there is dire danger in inflation. I was pleased to see, this week, a newsletter, going out from a Member of Congress, who said, in effect, unpopular as it may be, as it has been said to be—and I don't believe it is unpopular—I am for taxation in place of inflation, and that even in an election year. I think that what we really are seeking is, first, knowledge of when a tax increase or decrease should be given, for fiscal purposes; and, secondly, which is the most effective and the fairest of all these to give?

And it seems to me that the fairest must hit everybody. You can't just hit some. You have got to hit them all. I think that we need to know the time when action should be taken and, if you would give us your idea of when that time has arrived, we would be pleased to hear it.

Mr. SONNE. You mean when the temporary——

Representative GRIFFITHS. Yes; what are the things which you consider the indicators for a tax increase or decrease?

Mr. SONNE. You mean the temporary tax we are talking about?

Representative GRIFFITHS. Yes.

Mr. SONNE. Because the other thing will take quite some time.

Representative GRIFFITHS. No; we are not going to put the added-value tax on this morning. [Laughter.]

Mr. SONNE. Well, if you sit here and figure when should we do this, what you want to avoid is an inflation with higher prices, more trouble—meaning labor still wants higher wages, and so forth, and so forth—if you are wrong in your judgment and we get what you may call inflationary pressure, it is very unfortunate.

If you start early, and as a result there becomes something of a little recession, the damage is less severe. And therefore, if you ask me when to do it, I am almost looking at my clock to say, "Tomorrow; 12 noon."

But I have a much greater argument in favor of this; as I mentioned previously, we were to discuss, and naturally so, domestic things. The average citizen does not understand that our situation domestically is very much dependent on our international situation—where we stand, rather unfortunately, with huge debts—and, when you read people criticizing us domestically for raising interest rates, for instance, the same people don't realize or think of that when Britain—who is is in a difficult situation like ours, and worse—when the Labor Prime Minister there raised, or permitted the Bank of England to be raised, to 7 percent, the world said, "There is a good boy. He shows that they want to do something."

We have got to do something toward the world, so to show them that we're not going to go on spending and spending and spending. We are doing something ourselves to get our economy in shape, that was done in part, but only very small part, by Martin some months ago.

As compared with what money really is worth, it is ridiculous for people saying it. Our interest rates are far too low, but that is another story.

But if we come out with something that you are discussing now, and we say, now we are raising a temporary tax, with an idea of avoiding inflation, with an idea of really putting our house in order, that is more important for the world opinion than the step itself, because things have—things happen very often much more as a result of the repercussions from your ideas than from the ideas themselves, and consequently, I regard it as a very important issue which you are looking into, and I regard it as one in which I hope you will get through in some form or another—I am not so specific on details—very quickly.

Let that be my answer.

Representative GRIFFITHS. Thank you. Mr. Neal?

Mr. NEAL. I would like to take advantage of the suggestion implicit in Senator Proxmire's question, that if you want a stabilizing budget which will take some of the pressure off monetary policy, and naturally take the steam out of inflation, you have to have a budget surplus at this time.

But it may well be that the administration has, as it usually does, spending plans and plans to withhold spending which would bring them to change their own budget forecast. If the administration has in mind reducing expenditures or holding back expenditures, as well as some of these asset disposals and so on that would bring about a change in the surplus, those possibilities should be explored, if only as a formality to make it clear that both expenditure and revenue have been looked at. But if the present budget or anything like it stands, then the time for getting that surplus is now, and that means the time for a tax increase is now.

Mr. SONNE. May I add on these that I have also spoken, in other words, on the basis—and I thought that that was understood—that the present Government had come out in their statement and said they are not going to give up the expenditures for the poor, on account of the present situation.

Representative GRIFFITHS. Yes.

Mr. SONNE. Granted that, in other words, I have not demanded a surplus, yet, because I maintain we are still in a very difficult position because we shall have to help the people abroad. I would not call our conditions normal. But I would like to see a tax, in some form or another, that would balance our budget, with today's expenditures.

If then meanwhile, our Government can see their way of deferring some expenses, we will get a surplus. And if they really work, as I told them the other day, when you have a budget of $100 billion, I think, there are very few people that can't save a few billion dollars, if they realize they really must.

But that is another story. In other words, the minimum we ought to have is a balanced budget.

Representative GRIFFITHS. Senator Proxmire?

Senator PROXMIRE. I might say, Madam Chairman, that to the extent the Republicans were defeated because of their tax cut, it seems to me it was largely because of the kind of tax cut they had. I think the American people were convinced it was not a fair tax cut, because most of them did not get it.

There was supposed to be a tax cut, but 78 percent was for corporations, and practically all the rest was for people with incomes far above what most people had.

Representative GRIFFITHS. Well, at least in my district that was right.

Senator PROXMIRE. When everybody gets some tax cut, it tends to be more popular.

I found that out to some extent in the last election, because I voted against the tax cut, and it was not the best issue I had in the last campaign. [Laughter.]

Mr. Neal, I think that you can make an argument showing that the corporation income tax inhibits its growth where the value added tax would not, but I wish you would make that argument very briefly, for the record, because you and Mr. Harberger have both urged this on us, and you are both impressive advocates, but I don't think that we have in the record a showing of how this works.

Mr. NEAL. Yes. Well, there are basically two simple arguments. One has to do with the availability of funds for investment and the other has to do with the profitability of investment. In considering an investment, you consider return after taxes. And if you have a 50-percent corporate income tax, it means that an investment that would yield 8 percent after taxes, the investment has to make 16 percent before taxes. For example, if you cut corporate taxes so that a 12-percent yield, gross, will give you the same 8-percent yield, net, obviously, you can extend investment out into a great many things that otherwise would not be profitable.

Senator PROXMIRE. Now we are talking about just taking off the corporate income tax. We are talking about substituting to some extent. Why wouldn't the value-added tax also diminish your return?

Mr. NEAL. The value-added tax is imposed upon gross receipts, rather than on profits on investment. The base is different. And as Madam Chairman rightly pointed out, it is assumed that the corporation would by and large be able to pass on that tax. It would not affect the rate of return, except in the immediate period after the imposition.

Senator PROXMIRE. What you are saying, because this is a sales tax, primarily——

Mr. NEAL. Acts like a sales tax. Now as Mr. Sonne pointed out, the corporate income tax itself probably acts the same way.

Senator PROXMIRE. Well, this depends entirely upon the competitive situation.

Mr. NEAL. It does.

Senator PROXMIRE. And other factors of this kind.

Mr. NEAL. Exactly.

Senator PROXMIRE. Obviously, with a utility, it is wholly passed on, because they are permitted to earn a specific rate of return.

Mr. NEAL. Exactly.

Senator PROXMIRE. In a highly competitive industry, it might be quite different.

Mr. NEAL. Well, in the long run—not Keynes' long run, sir—but over a long period of time, your analogy to the utility is applicable everywhere. That is to say, if you don't earn a competitive rate of return, capital will not flow into that particular industry, so over time, a corporate income tax tends to be passed on, and the big argument is how long it takes, and so on.

Senator PROXMIRE. Passed on to several people. It is passed on to the stockholders, it is passed on to the employers, and it is passed on to the consumer.

Mr. NEAL. Yes, and economists are divided as to what the incidence actually is. Our own working principle is that there is not an awful lot to choose between the two taxes, so far as incidence is concerned.

But may I make my other point, sir, about why corporate income tax inhibits investment? The other point is equally obvious. It is that a great part of the investment made in the private sector is made out of the retained earnings, so that to the extent that you can leave more earnings with the company that earns them, less going into the Government, you have more money to invest.

Senator PROXMIRE. This is on the assumption, then, that the value-added tax is going to increase prices and contribute to inflation by being passed on to the consumer, and for this reason, you say that the manufacturer or the corporation would have more left to invest in plant and equipment.

Mr. NEAL. That is a very good statement, sir, except the part you put in the middle, about contributing to inflation.

Senator PROXMIRE. It certainly does. It raises the prices to the consumer. Furthermore, it means that at the time we are suffering inflation from this heavy investment in plant and equipment, we are going to get more of this investment.

Mr. NEAL. Well, this argument is—and I hate to drag this in—this is like the argument that raising interest rates raises prices, and, therefore, is undesirable.

Senator PROXMIRE. It does, to some extent.

Mr. NEAL. It is true that some prices are raised, but if the total effect on the economy is to dampen down demand, there will be other prices that would have gone up that don't, or some that actually have to go down.

Senator PROXMIRE. Yes, but a rise in interest rate, I suppose, theoretically dissuades people from borrowing. But a rise in prices, because of the value-added tax, would act like any inflationary increase, and any inflationary increase tends to discourage people from buying to some extent, but not in the same decisive way that a postponement of big investment expenditures because of a rise in interest would.

Furthermore, to the extent that this is not passed on, it seems to me what happens is that the big corporation, which pays the 48-percent tax now, would be benefited certainly by reducing the corporation income tax, but the small business that pays the 22-percent normal tax and has an income of less than $25,000 a year, would be perhaps adversely affected, and a marginal firm that is having a tough time staying alive would still have to pay the value-added tax, wouldn't have to pay any corporation income tax at all, would be hit hard, so it is regressive as far as the business unit itself is concerned. Isn't that correct?

Mr. NEAL. Yes. As a matter of fact, that is a rather good analysis which we have gone into ourselves. We don't believe quite so much that business should be protected against the pressures against inefficiency in the American economy.

Senator PROXMIRE. Well, you would not argue that small businesses are inefficient?

Mr. NEAL. No. I was referring to the last point you made, sir. Small businesses have special difficulties and they have special dispensations, both taxwise, and from the standpoint of the loans available to them, and so on. But the point about a business that does not make profits having to pay value-added taxes extends over into the business field a concept of equity that you use in personal income tax.

Now, business perhaps should be equitable, but we don't have to be that equitable in thinking about them. Business should be efficient, and businesses that are losing money, and especially in a high employment economy, either have to turn themselves around so they can make money, or they have to get out of the way.

We don't have excessive unemployment anymore, so the point about a value-added tax bearing on a business that is losing money is a point, I think, that does not fit a high employment economy where you want to get better and more efficient distribution of resources.

Senator PROXMIRE. But you would apply the value-added taxes at all times. You say that you would like it as a permanent system, so you would have it when you have 7 and 8 percent unemployment, and when you have a business cycle situation in which a firm is losing money because it is in a cycle.

It might be a very efficient firm over the long pull, but it would not be making money, and yet it would have this extra burden under your proposal.

Mr. NEAL. Yes, just as it has now, with all the property taxes and sales taxes.

Senator PROXMIRE. Yes, but you would add to it with a value-added tax. We would add something.

Mr. NEAL. We would add something. I did not expect I would have to argue in favor of adding burdens on business.

Senator PROXMIRE. Well, furthermore, to support what the chairman has pointed out, what is the thrust, after all, of this hearing, and the reason why we are interested in this, among other things, is to determine what kind of tax would be best to stem inflation.

Now the value-added tax does have the great weakness, it seems to me, of raising less revenue in the period when the business cycle is up and business is expanding, and you should take more revenue out, than the corporation income tax.

Or than the personal income tax. The higher the rate, the more progressive the rate, the more you can tap off with a progressive corporation income tax, the less with a flat value-added tax; isn't that correct?

Mr. NEAL. Yes, except the corporate income tax, except in a very minor way, is not progressive either. It is a flat rate tax with certain exemptions favoring small business, as you point out.

Mr. SONNE. May I just comment?

Senator PROXMIRE. Before Mr. Sonne speaks, let me simply say it is certainly progressive in terms of the cycle, though. After all, if in a particular year, General Motors is making a billion dollars, and it is making only a hundred million dollars in the next year, when you have the corporation income tax, it obviously will take off a great deal more in that boom period, when you want to take it off, than in the recession period, when you don't want to take it off.

Mr. NEAL. Yes; we have difficulty in words like "progressive." I was thinking of an increased percentage of tax on higher incomes.

Senator PROXMIRE. So from this standpoint not only would the value-added tax increase the price level, by imposing a kind of sales tax on the consumer, but it would also be less stabilizing, and certainly have less effect in dampening down inflation.

Mr. NEAL. Sir, I just want to put in the demurrer that I would not agree that the imposition of a value-added tax, by itself, would necessarily raise the price level, because of this budgetary overall demand effect which must not be lost sight of.

Whereas, it is true, some prices would be raised by the amount of increases in the taxes, total demand would have been reduced by the collection of the tax.

Senator PROXMIRE. It is true of any inflationary development. It always tends to do that.

Mr. NEAL. Yes; it would have, I think, the same inflation or deflationary effect that any other form of tax would have.

Senator PROXMIRE. This is kind of a 1984 concept, you know, "black is white." In other words, you raise prices in order to stop inflation.

Mr. NEAL. Precisely like that interest rate analogy, sir.

Representative GRIFFITHS. Mr. Sonne.

Mr. SONNE. You see, our feeling about the value-added tax is that it is a little more productive under inflation than the corporation tax. I mean, from the point of view of receipt of the Government.

Senator PROXMIRE. A little more productive?

Mr. SONNE. It would give you more than the corporation tax.

Senator PROXMIRE. No, no, sir; I disagree with that very strongly.

Mr. SONNE. Because as prices are higher, the percentage of value-added taxes, a certain percentage of the goods that you sell, the values of the goods you sell go up, and consequently, the things you collect, the amount you collect is bigger.

Senator PROXMIRE. No, no, the argument that I am trying to make, Mr. Sonne, is that the most volatile element in the economy is profits, and as profits boom, in a period of prosperity, what happens is the corporation income tax takes a substantial amount of those profits.

The corporation income tax has been extremely volatile, whereas, if you simply have in effect a flat tax on sales, or gross receipts, gross receipts don't vary nearly as widely as profits, so that in a period——

Mr. SONNE. And with the value-added tax, you mean you might have a loss now and again?

Senator PROXMIRE. That is right.

Mr. NEAL. Could I interject——

Mr. SONNE. It certainly gives you participation in profits, or whatever you make, and inflation, there generally is greater participation in profits. I would say that it is a more desirable tax to collect from the point of view of the Government than just an ordinary tax.

Senator PROXMIRE. It is certainly a more desirable tax from the standpoint of the profitable corporation. There is no question about that in a value-added tax.

Mr. SONNE. My main point is this one—because otherwise, the two of you are experts in these things—you forget one thing. The value-added tax has great value in our foreign trade and exports, for the reason that we are up against the diabolical way in which the Europeans compete with us abroad, and they deduct certain kinds of taxes, in figuring the cost. We want—we can't deduct the corporation tax in figuring the cost, but we can do it with the value-added tax, and therefore, before you discard the value-added tax, please look carefully into this.

And also realize that next to high employment and Vietnam, the balancing of our foreign trade balance is the most important problem that faces this country.

Senator PROXMIRE. Fine.

Mr. SONNE. You can do so, and if you can do that with a value-added tax, it may be worth while considering.

Senator PROXMIRE. My time is up.

Representative GRIFFITHS. Go ahead.

Mr. SONNE. Sorry I took your time.

Senator PROXMIRE. No, no. Just let me say that everyone, without exception, in these countries that have so-called more favorable tax systems, or the value-added taxes, as Frances does, has had a greater increase in prices than we have had. Furthermore, we are world champions in our world trade balance. Our problem is not being able to sell more exports than our imports. This past year we had a $7 billion favorable trade balance. It is true we have an adverse balance of payments, because we have foreign aid, troops stationed all over the world, and there are many other reasons, but as far as the ability of our American business to compete, we have done very well. Our labor costs have not risen as rapidly as in other countries, and we have done well.

I can't see any argument that our tax system has been so bad that our trade balance has suffered.

Isn't it true Mr. Sonne, that our trade balance is better than in other countries?

Mr. SONNE. Let me put it this way——

Senator PROXMIRE. Can you name another country that has a trade balance of $7 billion?

Mr. SONNE. No; because those other countries have not got the liabilities, you see. We are accustomed, going right back in history, always to have had trade balance excesses. But we need a trade balance that is bigger than it is today, if we want to afford to be able to have our military establishments abroad, and to help other countries.

Senator PROXMIRE. Well, we want to do that, that is true.

Mr. SONNE. I was going to answer and say I am glad if you are satisfied with our balance of trade last year. I was not.

Senator PROXMIRE. Well, I would like, everybody would like to see it improved. But I say it is hard to make an argument that is it is so poor that other countries are doing better when we are doing better than they are.

Let me just get to another couple of things quickly. Do I understand you to say that by increasing the tax in the low brackets that you would be able to fight inflation by cutting down on food consumption? People would eat less?

Mr. SONNE. I hope not.

Senator PROXMIRE. Well, I am glad you correct me for the record, because that was my understanding.

Mr. SONNE. I would say this: For a person that has $30,000 a year, his food budgets may be $3,000 or $4,000, or something like that, perhaps 10 percent; but for a person that only has a small income, the part of his budget for food is relatively larger. And, therefore, he is relatively more interested in keeping prices down. But I certainly hope that they would not starve on that account, but my whole point is that——

Senator PROXMIRE. Well, isn't this the consequence? After all, if you are going to increase the taxes on the people in the lowest income bracket—you just said they spent maybe 25 or 30 percent of their incomes on food.

Mr. SONNE. If you want to talk, and do it with due regard to where the chips fell, you have to say that the keeping of food prices down is relatively more important for the poor than for the rich, because the poor man has 25 percent of his income involved, and the rich man has only 5 percent of his income involved. That does not mean that I want to tax him; but I just say, if you want to do it, then keep that in mind.

Representative GRIFFITHS. But in reality it does not make any difference to the poor whether he can't buy pork chops because of inflation or he can't buy them because of high taxes.

Mr. SONNE. That is right.

Representative GRIFFITHS. I mean, he comes out the same thing—minus pork chops and eating beans.

Senator PROXMIRE. You don't solve his problem by increasing his taxes.

Mr. SONNE. No, we do not.

Senator PROXMIRE. Then, at any rate, it would seem that as far as food is concerned, we can manipulate the supply side far better to meet our problem, it would seem to me.

Mr. SONNE. But if I had $4,000 income, and knew that I would have to pay an added $20 to this tax, and knew that as a result, I could save a hundred dollars in my food bill next year, I would not be so very depressed over the situation.

Senator PROXMIRE. Let me ask you—in your statement you said that you feel that we should expand or cut the budget primarily for economic reasons. If I understand you to argue that we might try and do that, or that we should do it?

I think this is an interesting suggestion. This is one of the purposes of the Joint Economic Committee, to try to influence congressional policy on the spending side as well as on the tax side; but it is a terrifically difficult thing to do; and unless we have some kind of institutional change or something of the kind, it is hard for me to see how we are going to do that, because we have defense spending, which is our biggest by far, of more than half of our budget; and the position that all of us take is that we should not consider anything except the defense needs of this country, disregarding any economic consideration.

We have other fixed longrun programs that are very difficult to change without considerable inefficiency. We have our programs for education to promote growth, and so forth, that are hard to adjust or change, and we have welfare programs which most people feel we should not reduce.

There are a few things, like construction expenses, public works spending, which I think we should arrest, and can, but short of that, I wonder if you can suggest anything else that we could change, and limit?

Mr. SONNE. I see. My position is this: That I think we need a temporary additional tax, so as to be able to sit down and see what we really should do, and there it is that I say that I am perfectly satisfied, if as a result of that temporary tax, whatever you decide on, we balance the budget.

My friend would like a surplus, but I hope to get that surplus out by the Government sitting down and carefully study where it can be saved. Now I admit it is very difficult to save. I agree with you on Vietnam, and so forth, and I was just mentioning that one way in I think a great deal could be done, and I am serious about it, is that where we are fighting for our lives, and those of our boys, I don't see why hundreds or thousands of Americans should go over in Europe and drink in the Ritz bar.

I don't want to forbid them doing this, but I don't see why we don't take a tax of so many dollars for going out and coming back again, so as to discourage it.

That would be a saving coming in, mainly I think morally—other countries have done that. In a private family, when the income is low, the family does not go out and have a good time on the summer vacation. Why should we go out and spend our money there—abroad?

That is one of the things we can consider.

Senator PROXMIRE. You see on that particular score, what we try to do is to impose a sacrifice by progressive income tax, and then let the recipient choose, freely choose whether he wants to travel or not. A great deal of travel abroad, I think you would agree, is desirable and necessary, it is teachers traveling abroad, students, and others—and other citizens.

Mr. SONNE. Yes, but, sir, I have been a member of various clubs for many years where a $100 or $150 were taxed by the Government for membership in the club.

All right, now they have given that up. By the same token, I say, if I go out at a time where our balance of trade is wrong and spend thousands of dollars abroad, I would like to see that I have to make a certain sacrifice and pay something to the Government, because it would remind me that I am really doing something that is wrong.

And I am not talking about a young fellow that has to go out and be educated. That can be arranged, certainly; but I am talking about the masses that don't know the beauty of our country, and spend it right here, and go over there and spend it, for absolutely no reason.

Senator PROXMIRE. Let me just ask you on one other subject, and then I am through.

You suggested that we suspend the investment credit and Mr. Neal disagreed with you. I agree with Mr. Neal, for two reasons, and I wondered if you could meet these.

No. 1 is that this is a tax credit which it seems to me depends very heavily on certainty, and you introduce an element of uncertainty when you suspend it now and the businessman does not know when it is going to be suspended in the future.

The credit becomes unreliable; and, as President Johnson has said, certainty is very important to the business community.

The second point which concerns me is that the Treasury supports what Mr. Neal has told us, that there is a lag of between 9 and 12 months, or more, in new equipment which is the only area where you would suspend the investment credit, and if there is a lag that long, forecasting is not very good after a year.

We might have a deflationary situation a year from now. Does it seem, under these circumstances, wise to suspend the investment credit?

Mr. SONNE. I will gladly try to answer.

Am I right in assuming that such a step might run up to a billion dollars? Now, just to know what we are talking about here.

Senator PROXMIRE. There has been as an estimate in that area.

Mr. SONNE. Have you estimated that?

Senator PROXMIRE. A billion dollars, if you suspend the whole investment credit.

Mr. SONNE. Then it would be pretty close. Now what I point out as I said, that we have been through here in the last 16 years, a number of points, and one of the points that was to go from war to peace, which involves a reestablishment, reorganization of our plants, which not alone means our local things, but also our businesses, so as to be able to compete and get the modern machinery in.

Now that is something that happens to every country when they have been at war, particularly for a long war, when local things have been neglected, and their factory is old fashioned and normally speaking, a new factory, if I am in industry, is being built when I figure out that now is the time that I can make money on that new building. I don't need to get any tax concessions from the Government to do a thing that is economically sound.

But we were here some years ago in a situation where business was poor, where it was difficult for them to finance, and where we felt in the Government we ought to give a certain encouragement, tax return on certain things, in order to make it easier for them to do what they ought to do anyhow.

Now I am still all for that, as I say, but now it is not business that much so much that is in trouble, but the Government that is a little in trouble. We don't know what to do. We want to save something here, and we say, let's go a little slow on that, because it is going at a rate which is a little higher than I have ever seen in this country, and I say, that does not mean that I stop, necessarily, that plants and good industry be improved, because if there is an industry now that needs a new plant, and as a result of that, can reduce its prices and compete abroad, and sell and make big money, they will start that new plant without that 7-percent tax from the Government.

That is my argument. But I don't feel very strongly on it.

Senator PROXMIRE. You see, there is just one other point on that, and that is that the investment credit has resulted in growth and expansion of plants and equipment.

Mr. SONNE. That is right.

Senator PROXMIRE. It has speeded up automation. It has meant that we can meet the demand better, and it has expanded the supply. It tends in the longrun to keep prices down. If you interrupt it, won't it interrupt this very desirable situation of expanding supply when we need it?

Mr. SONNE. I wanted just to stop you when you say, if you want to. In other words, it has done all that. And it is capable of doing it. And it is quite possible it will continue to do it without the tax, because normally speaking, a business community should not necessarily get tax deductions from the Government because they start a new plant.

A new plant should be there for economic reasons, because they make money on it.

Senator PROXMIRE. Well, I agree with you ideally, perhaps, but the fact is that you have the investment credit, and you had a clear demonstrable proven and unpredicted increase in business plant and equipment investment.

Not just recently. There may be other reasons there, but ever since it was put into the tax law.

Mr. SONNE. I would like to put it this way. If we can afford to continue to give that 7 percent to industry, I am all for going on. I was talking on the idea all along that we were in very low water, and we had to find something, and one thing, which is not absolutely necessary, we quit for a year or two, stop.

Representative GRIFFITHS. I would like to ask you, either of you, in connection with corporate taxes, and your suggestions that it be reduced, as soon as we possibly can do it, don't you feel that one of the reasons that American business moved so readily into Europe in recent years was not along their tax structure, but the belief of American business that Europe was going to create the kind of market in the Common Market that America understood?

Mr. NEAL. Yes; I think that one should not attribute the outflow of American investment merely to a difference in taxes.

But a difference in profit prospects, there certainly was.

Otherwise, these fellows need their heads examined.

Representative GRIFFITHS. The Common Market also made profit prospects even brighter.

Mr. NEAL. Yes. Now if Europe has been wise enough to create the conditions that make it more profitable to put your money there than to invest it here, if you don't want so much of it to go abroad—right now, anyway, and maybe not in the future—the outflow of capital to Europe demonstrated that there were more profitable longer run opportunities there. Further, the differences in the structure of taxes is likely to cause a disparity in profitability to remain on tax account alone.

The taxation of corporate profits, by and large, in Europe is lower, and the reliance for meeting government revenue needs is much higher on indirect taxes, such as this value added tax that I am talking about.

Representative GRIFFITHS. Now I would like to ask you, if we increase personal income taxes, and not corporate income taxes, is it not possible that some corporations will continue with their present rate of profit, or increase it, which will result in additional wage demands?

And thus, in a way, defeat the very thing you are trying to do? That is, I can't believe that, no matter what we do, people are going to buy fewer cars.

Mr. SONNE. Motorcars, you mean? Yes?

Mr. NEAL. May I suggest, Madam Chairman, the conditions that bring about wage demands are inherent in the way wages are negotiated. That is to say, one can't expect unions to forgo demands for wages whenever they think there is an opportunity to get them.

Representative GRIFFITHS. They will be much surer.

Mr. NEAL. The will use profits as an excuse, and the very pressure of demand on the labor market is such that they probably will get a part of which might look otherwise to be high profits.

Mr. SONNE. To answer your question about these investments abroad.

Representative GRIFFITHS. Yes.

Mr. SONNE. They came quite naturally when, many years ago—time flies—they began to talk about a common market, and the lively and able industries in this country argued: "Gee, here is going to be a move whereby the six countries are getting together. We don't know whether the so-called Kennedy Round will succeed; there may be a tariff war. We want to get inside that tariff war," and that is, of course, much more important—I mean, for the starting it—than the question of whether the corporation tax is a little higher. You have to have profit before you think of taxes, you see.

Representative GRIFFITHS. That is right.

Mr. SONNE. But here was the unfortunate thing; and, while I am probably more in favor of the 7-percent tax than you are, although I didn't realize it, that some years ago, before this tax came in, the thing that worried me about that move was that there was American business going over and building new plants which were better than their old plants, with the result that one day, if somebody controlled Europe—say, if an enemy country controlled Europe—they would also have the best American plant in the world, right in their hands.

I am showing you the picture. This lies some years back. Therefore, I am delighted at that 7-percent tax. I am delighted to think that now, in aluminum, and a number of things, we have the latest plants.

We can go still further. But that was one of the beginnings, the startings, and it probably should go on for some years; but I think you would probably agree that, at a certain stage—say, 5 or 10 years from now, when the job is done—you would not expect that 7 percent to be a permanent tax, would you?

Mr. NEAL. I think it is intended to be.

Mr. SONNE. You think it is intended to be? At any rate, I have not thought so.

Representative GRIFFITHS. No, I don't think it was intended when it was put on, but loopholes generally become permanent. Thank you very much, gentlemen.

This committee will adjourn until 2 o'clock this afternoon, in this room.

(Whereupon, at 12:05 p.m., the subcommittee recessed, to reconvene at 2 p.m., the same day.)

AFTER RECESS

(The subcommittee reconvened at 1:55 p.m., Representative Martha W. Griffiths, chairman of the subcommittee, presiding.)

Representative GRIFFITHS. Thank you very much, Dr. Madden, for being here. We appreciate your response to our invitation. Senator Proxmire will be a few minutes late, but I would like to ask you to start with your statement.

STATEMENT OF CARL H. MADDEN, CHIEF ECONOMIST FOR THE CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. MADDEN. Thank you, Madam Chairman.

My name is Carl H. Madden. I am chief economist for the Chamber of Commerce of the United States. Before joining the staff of the national chamber, I served on the staffs of the Senate Banking and Currency Committee, and the Treasury. I was dean of the College of Business Administration at Lehigh University and, before that, was an officer of the Federal Reserve Bank of New York.

It is a privilege to appear before this committee to present the national chamber's views on the need for possible temporary tax changes to stimulate or restrain the economy. It is our understanding that the committee wishes to explore this question in order to advise the Congress on ways in which greater fiscal flexibility might contribute to economic stability.

The Chamber of Commerce of the United States does not believe that there should now be additional tax features built into our existing

Federal tax structure. The chamber favors restraint in spending when fiscal stringency is indicated—as at present—in order to contain inflationary pressures; and we favor reduction in tax rates when fiscal ease is indicated, in order to stimulate the economy when it is operating below capacity.

ECONOMIC IMPLICATIONS OF THE FEDERAL BUDGET

The fiscal 1967 Federal budget is inflationary under current economic conditions. The projected administrative budget deficit of $1.8 billion is at best speculative, and at worst misleading. Further, the budget is bound to be more stimulative in calendar 1966 than in calendar 1965. An increase of $7.5 billion is set for Government purchases, and one-third of the supplemental for 1966 of $15.7 billion is scheduled to be spent in the first half of this year.

At issue is the timing of the impact of the Federal budget. It is argued that the inflationary impact of higher military outlays in the first half of calendar 1966 may be largely offset by the $5-billion increase in social security taxes that took effect on January 1. But, as Murray Weidenbaum has pointed out, the effect of military expenditures occurs in the private sector upon placing of orders, since such production remains in the private sector until delivery. It does not show up in Government expenditures until then. The contribution to economic activity occurs before Government purchase. So, as Dr. Weidenbaum indicates, it is a mistake to conclude that during periods of rapid increases in Government purchases private and not Government demand lies behind inflationary pressures.

Returning to the projected administrative budget deficit of $1.8 billion: it was achieved by what have been called "gimmicks" on both the receipts and expenditure sides. Among receipts, there is a seigniorage profit of $1.6 billion, private participation in Federal credit programs of $4.7 billion, and a shift to revolving fund financing of $0.2 billion. On the expenditure side, several proposed budget reduction programs may well not pass the Congress. These include agriculture, school lunch, and impacted school district cuts.

Other expenditures may also be underestimated, such as national defense, and aids to housing. As a matter of fact, the cold war GI bill recently approved will cost over $200 million more than the budget estimate. Finally, some of the budget proposals involve legislation which may not be enacted. These include user charges of some types and revolving fund proposals.

Even if the optimistic budget targets are achieved, the budget for fiscal year 1967 can still be inflationary. If a budget deficit, however small, is combined with monetary expansion at recent rates, the result could still be damaging to price stability. No one wants to see the remarkable record of economic growth and price stability end in a period of recrimination among Government, business, and labor. Yet the clear signs of inflationary pressures being generated by Government policy threaten to produce imbalances in the economy that could end our record expansion.

Besides monetary and fiscal policy, the Government's legislative policy in coming months could contribute to price rises by promoting an inflationary psychology. Proposals to increase minimum wages, to increase unemployment compensation taxes, and to add to the costs of credit and consumer items by cost-raising regulation deserve careful scrutiny in 1966 for their price-raising impacts.

Indeed, three of the four eminent economists who participated in a national symposium on inflation, guideposts, and economic policy sponsored by the national chamber on February 9, 1966, indicated that inflationary pressures are strong enough to warrant fiscal and monetary restraint this year. This was the view of Arthur F. Burns, Paul A. Samuelson, and Walter Fackler. All of them advocated careful scrutiny of expenditure proposals in 1966, including antipoverty expenditures made less necessary by conditions of high employment, in order to drive the budget toward a surplus.

THE CAPITAL SPENDING BOOM

In recent weeks the business and financial press has highlighted reports of great strength in business investment spending. Correspondingly, among academic economists the most widely mentioned tax-increase device has been suspension of the 7 percent investment credit that was adopted in 1962 to stimulate business purchases of capital goods. But this proposal overlooks the (unknown) extent to which forward buying, including that of defense contractors, is a factor in the strong demand for capital goods. To the extent that such forward buying is significant and is traceable to anticipated tax and price increases, prompt action to curb nondefense spending and restraint on the rate of credit creation would serve to clear the air and moderate, if not eliminate, such forward buying. More fundamentally, the investment credit is a desirable permanent feature of a good tax system, as was the revision in depreciation guidelines. At the time the investment credit was enacted the business community was clearly given to understand that this would be a permanent part of our tax laws. Accordingly, business firms have built this expectation into their long-range planning. This credit is of great importance in stimulating innovative and cost-reducing investment that is so essential to sound economic growth.

EMERGING STRUCTURAL IMBALANCES

The national chamber does not believe in the inevitability of a boom-bust pattern of economic development. Still, it is struck with several structural imbalances that have been emerging that threaten the continuance of stable economic expansion. First, there is the rise of prices following stability from 1958 through 1964. Second, there is the accelerating rise in labor costs—especially in the construction field—attending on overall unemployment rate below 4 percent and a rate substantially below that for experienced workers. Third, as less efficient machines and workers are pressed into production, productivity gains are tapering off. Finally, rapidly rising aggregate spending has been accompanied by huge borrowing. In 1965 the growth of public and private debt combined amounted to $90 billion. Commercial banks alone last year expanded loans by $25 billion, compared to an average of $15 billion annually in the 3 preceding years. This was made possible by the monetary authorities who pumped reserves into the commercial banks, resulting in a rapid and accelerating increase in the monetary supply.

The Government has been slow in recognizing the inflationary pressures generated by its monetary and fiscal policies. As late as last December the administration resisted the Federal Reserve's discount rate increase. The subsequent broad and general advance in interest rates indicates the strength of surging demands for credit not discouraged by the Federal Reserve's action.

In summary, the national chamber believes that the need for fiscal restraint is both clear and urgent at the present time. But, contrary to some views that have been expressed, the chamber does not believe that this restraint should be imposed on the tax side of the fiscal equation. If ever fiscal prudence were called for it is now when aggregate demands are pressing so heavily on productive capacity. Both the new economics and the old economics call for a budget surplus. The way to achieve that surplus is through spending restraints.

Representative GRIFFITHS. Thank you very much, Dr. Madden.

Would you mind naming the items you think should be cut from the budget?

Mr. MADDEN. We feel, Madam Chairman, that the problem of naming these items is that of the Congress of the United States. However, 17 committees of the chamber have met and have studied the budget and have proposed cuts in 51 different fields and I shall be glad to furnish you with this information.

Representative GRIFFITHS. Please do.

(The information subsequently furnished, follows:)

ALTERNATIVE TO INFLATION—51 WAYS TO SAVE OVER $3.3 BILLION

(National Chamber of Commerce recommendations for reductions in the Federal budget)

FIFTY-ONE WAYS TO TRIM THE FEDERAL BUDGET—CHAMBER'S PROPOSALS WOULD SAVE OVER $3.3 BILLION

Following an intensive analysis of the Federal budget for fiscal 1967, the board of directors of the national chamber has recommended 51 ways to save $3,345,305,000.

Acting on a study prepared by 17 national chamber committees, the board stressed that its recommendations "should not be considered a floor but a ceiling on the appropriation. Further reductions, if they are supportable, are much to be desired."

The board urged "that Congress also examine other areas of the budget and make further cuts where they can be effected without impairing urgent national needs."

As shown by the analysis and recommended reductions, which are given in details below, the chamber focused its attention on nonessential programs many of which would result in increased Federal intervention in State and local affairs and some of which may actually fall outside the scope and intent of existing legislation and authority.

The budget cuts recommended by the chamber represent also an attack on the inflationary pressures rapidly building up in our economy. As such, they present a feasible alternative to higher taxes to finance greater Federal spending. As noted this week by Senator Minority Leader Everett Dirksen (Republican, of Illinois): "The Johnson administration, now concerned with inflation, prepares to meet it by higher taxes rather than through a prudent budget. There are alternatives. One is to trim the budget * * *."

The 1967 budget can be trimmed. Here are 51 ways to do it.

Funds appropriated to the President

Economic assistance:	
Budget requests	$2,468,962,000
Recommended reduction	187,000,000

The request includes $500 million for "supporting assistance" for Vietnam. Under present circumstances this amount should be approved. However, the necessity for providing funds covering increased military operations in Vietnam, the uncertainty of future military requirements, and the acknowledged inflationary pressures, generated in part by the increase in spending for "Great Society" programs, dictate that authorizations for foreign assistance programs, other than in Vietnam, should be held at the level of 1966 appropriations. A reduction of $187 million will accomplish this objective.

Office of Economic Opportunity:

Budget request	$1,750,000,000
Recommended reduction	250,000,000

The Economic Opportunity Act of 1964 authorizes 10 major programs intended to combat poverty. Under this act spending has risen sharply. The obligational authority for this fiscal year 1966 is double that of 1965. At present, insufficient means are available to evaluate fully this program. Some scattered success is indicated among aspects of the 10 major program areas; however, there is apparent disregard for unit costs, effectiveness of management, and evaluation of results.

Without evidence of either efficiency or appropriate results, the national chamber recommends that obligational authority for 1967 should be restrained to that of the current fiscal year. The chamber further recommends that the educational activities authorized under this act (such as Headstart, Neighborhood Youth Corps, and Basic Education) should be transferred to the programs already operating in the Office of Education of the Department of Health, Education, and Welfare. Without such coordinative management, the national chamber questions whether the educational programs now in the Office of Economic Opportunity can ever achieve their stated purposes.

Peace Corps:

Budget request	$110,000,000
Recommended reduction	10,000,000

The chamber recommends a reduction of $10 million in this request. Even though the request is $4.1 million below 1966 fiscal year appropriations, the chamber continues to recommend that this program be consolidated in the area already in the program before a further expansion of the number of volunteers be undertaken.

Department of Agriculture—Agricultural Stabilization and Conservation Service

Cropland adjustment program:

Budget request	$200,000,000
Recommended reduction	170,000,000

Funds for carrying out this long-term program should be withheld. To the extent that the $30 million already allocated from CCC funds for initiating this program in fiscal year 1966 remain uncommitted, further expenditures should be denied. The CAP program provides for 5- to 10-year contracts with producers to divert land from the production of unneeded crops to other uses. It will contribute little to curtailing current crop output and enhancing farm income opportunities.

There were roughly 50 million acres "retired" under various programs during the 1965 crop season. The acreage diversion programs for feed grains, wheat, and cotton are on an annual basis, and thus provide more flexibility for cropland adjustment than does the new cropland adjustment program. In addition, current and anticipated priority requirements for national defense and world hunger suggest that it would be unwise to withdraw additional cropland from production on a long-term basis.

As for diverting this land to other uses (conservation, recreation, and the preservation of open spaces, and natural beauty), there are other Federal programs already supplementing extensive private incentives to meet these needs.

Expenses:

Budget request	$135,891,000
Recommended reduction	10,000,000

The cost of administering the new CAP program is estimated at $10 million. Accordingly, the national chamber's recommendation to discontinue this program should reduce ASCS expenses by this amount.

Federal Crop Insurance Corp.:

Budget request	$8,546,000
Recommended reduction	354,000

The Crop Insurance placed this program entirely on an experimental basis to provide the means for research and experience helpful in establishing such insurance. Subsequent authority has permitted expansions into additional crops and new areas. Premiums have exceeded indemnities in 8 of the past 9 years. Income from operations is adequate for 1967 at the current program level, exclusive of administrative expenses. The crop insurance premiums should be gradually increased to permit the complete self-sustaining operation of the program, including administrative costs.

Rural Electrification Administration (loan authorizations):

Budget request	$305,000,000
Recommended reduction	112,587,000

Although the original goal of electrifying farms has been substantially completed, this programs has continued to grow. The recommended reduction would return the program to a level sufficient for any remaining rural electrification needs in keeping with the intent of the act. The legislative proposal of creating a revolving fund account for REA loans should not be approved because it would diminish congressional control over their operations and seriously weaken congressional spending control.

Rural Community Development Service:

Budget request	$3,468,000
Recommended reduction	3,468,000

The national chamber again recommends denial of funds for this agency until there is more convincing evidence that its services are needed for the effective development of rural America. This agency is not responsible for the administration of any program enacted by Congress. Much of its informational and extension services appears to be in duplication of the services of other agencies of the Government. Three other agencies of the Department have offices in nearly every county of the Nation—the Extension Service, Farmers Home Administration, and the Soil Conservation Service.

Forest Service (forest protection and utilization):

Budget request	$225,188,000
Recommended reduction	1,946,000

An increase is shown in water resource activities for further development of recreational facilities in the national forests. The same is true for land acquisition to protect watersheds of navigable streams and to increase production of timber. Funds for these programs should come from the land and water conservation fund which was created for this purpose.

Assistance to States for tree planting:

Budget request	$1,000,000
Recommended reduction	1,000,000

The States, forestry agencies, and foresters in general recognize the economic values in planting forest lands. Production of timber crops is an income-producing venture and the States should be expected to invest in and bear such costs on State-owned forest lands.

Department of Commerce

Community Relations Service:

Budget request	$2,000,000
Recommended reduction	250,000

The present request for $2 million by the Service substantially exceeds the amount ($1,300,000) appropriated by the Congress in fiscal year 1966. A reduction of $250,000 would in large part encompass proposed staff personnel increases that are questionable in light of broadened acceptance of civil rights legislation throughout the country.

Bureau of Public Roads (highway beautification):

Budget request	$91,750,000
Recommended reduction	21,000,000

In light of the potential economic requirements of the war effort, it is seriously questioned whether any funds whatsoever should be spent for this program. This type of program does not have economic growth building characteristics as other programs do, and should not be expanded to the extent proposed.

Department of Defense

Corps of Engineers—civil functions (general investigations):

Budget request	$32, 078, 000
Recommended reduction	2, 600 ,000

Comprehensive planning need not embrace the expenditures of large sums of money to conduct detailed and costly field investigations and designs of specific projects that obviously will not be built for a great many years and which would almost certainly be outmoded by the time the projects were to be under construction. It is further recommended that any planning funds for new starts be withheld where immediate need cannot be supported.

Construction, general:

Budget request	$970, 726, 000
Recommended reduction	5, 500, 000

The $5,500,000 for recreation facilities on completed projects should, if justified, be funded by the self-sustaining land and water conservation fund which was created for this purpose. All new construction starts should be reviewed with reductions in mind for those not clearly needed at this time.

Department of Health, Education, and Welfare

Vocational Rehabilitation Administration (grants for rehabilitation Services and facilities):

Budget request	$259, 060, 000
Recommended reduction	37, 000, 000
1966 supplemental request	39, 000, 000
Recommended reduction	12, 500, 000

The chamber supports the Vocational Rehabilitation Administration's program of preparing physically and mentally handicapped persons for entry or reentry into the world of work. However, based on performance to date, there is serious doubt of the ability to achieve a 23-percent increase in the number of persons to be rehabilitated. A reasonable estimate for the 1967 workload would be 175,000 rehabilitants with costs of $199 million—$37 million less than the amount projected. Similarly the projection in the 1966 supplemental request appears to be overstated by $12.5 million.

Office of Education (elementary and secondary educational activities):

Budget request	$1, 342, 410, 000
Recommended reduction	375, 410, 000

Legislation is proposed to extend the Elementary and Secondary Education Act beyond 1966. The 1967 budget estimate is based on this extension. It is probable that the constitutionality of this act will be contested in the courts. Under the existing act, four programs are set up—to aid educationally deprived children, procure school library materials, supplement educational centers and services, and strengthen State departments of education. Inordinate expansion may result through variations in a definition of low-income children. Continuation of the act could lead to Federal standardization of curriculums, texts, and methodology in public schools. New obligational authority for fiscal year 1966 was $967 million. The 1967 appropriation should be no greater.

Higher educational activities:

Budget request	$475, 272, 000
Recommended reduction	256, 649, 000

Under the Higher Education Act of 1965 grants and payments are made under eight programs to States, educational institutions, and individuals. Funds for student aid already are available—through private, State, and Federal programs (as the National Defense Education Act). Federal education and training programs should be consolidated and duplications eliminated. Use of private funds to achieve educational goals should be encouraged. A supplemental request for

1966 of $24,200,000 is in view; these dollars would initiate two of the programs named within the act; i.e., library assistance and the National Teachers Corps. New obligational authority for fiscal year 1967 should be no greater than the $218,623,000 appropriated for fiscal year 1966.

Higher education facilities construction:

Budget request	$722,744,000
Recommended reduction	259,594,000

Through State, local, and regional efforts, public community colleges and technical institutes are developing rapidly. The expanded program of grants proposed for 1967 under the Higher Education Facilities Act of 1963 is not needed in order to stimulate the expansion of colleges and universities. New obligational authority for these programs should be restrained to the level of fiscal year 1965.

Salaries and expenses:

Budget request	$41,563,000
Recommended reduction	3,650,000

Last year the Senate Committee on Appropriations recommended that the Office of Education "take no steps toward any national testing program, directly or by contract, until the Congress has had an opportunity to determine such a policy is advisable." Despite this, the budget for fiscal year 1967 includes $750,000 for expanding and improving both the regular statistical program and further development of the analytical model of the educational systems of the United States.

The sum of $2.9 million is included also for developing a new program of collecting educational achievement data on a uniform nationwide basis for the purpose of assessing the quality of education, for the purchase of data to be collected as a supplement to the current population survey, and to initiate a survey of adult education and training for employment. The national chamber recommends that the Appropriations Committee's statement be observed. The Federal Government should not establish a national testing program for all public schools, nor should the Government establish their curriculums or provide and subsidize accepted materials of instruction—such as textbooks.

Federal Water Pollution Control Administration (proposed pollution control legislation):

Budget request	$74,100,000
Recommended reduction	74,100,000

In view of the current controlling act providing the States an opportunity to initiate and implement their own water quality criteria, any proposal for new legislation and funds should be denied on the grounds that such proposal is premature. It is proposed that selected watersheds clean river demonstration projects be established and carried out. In addition, legislation will be proposed to strengthen enforcement procedures, including registration of all waters discharged into navigable rivers. These proposals could be in direct conflict with existing laws. We support the need for pollution abatement, but desirable implementation is a requisite for accomplishment. This legislation could become restrictive to ongoing positive action now in progress and prompted by the Water Quality Act of 1965.

Department of Housing and Urban Development

Office of the Secretary (salaries and expenses):

Budget request	$9,785,000
Recommended reduction	3,285,000

This account covers those salaries and expenses costs of the Office of the Secretary which are not reimbursed from other accounts. The amount requested for fiscal 1967 is approximately 67 percent above that for the current year. Since such an increase appears to be grossly out of line with projections of related operations of the Department (for example, project inspection and services activities costs are estimated to increase about 12 percent), it is recommended that the request be reduced by the indicated amount.

Office building equipment and furnishings:

Budget request	$575,000
Recommended reduction	450,000

The Department of Housing and Urban Development will soon be moving into a new central office building which is now being constructed, and the above budget request is for equipment and furnishings in connection with initial occupancy of that building. It is recommended that the Department utilize its existing equipment and furnishings to as great an extent as possible, and that the request be reduced to cover, where needed, regular replacement of wornout items and special equipment which could not be moved economically from current locations to the new building.

Urban studies and housing research:

Budget request	$750,000
Recommended reduction	350,000

Under this budget account, statistical data collection for providing market guidance to homebuilders and producers of building materials is conducted. Also, funds are used for studies on preparing and administering Federal programs and for managing community development programs at the State and local governmental levels. For several years prior to the current one, this program was carried out at an appropriations level of approximately $400,000. However, during the current year, substantial increases are expected, and these increases are projected for the fiscal year 1967 in the budget. It is recommended that this program be rolled back to the level existing in fiscal 1965 and prior years, and that the budget request be reduced $350,000.

Study of housing and building codes, zoning tax policies, and development standards:

Budget request	$3,000,000
Recommended reduction	2,500,000

The Housing and Urban Development Act of 1965 authorized a study of (1) State and local urban and suburban housing and building laws, standards, codes, and regulations and their impact on building costs; (2) State and local zoning and land use laws, codes, and regulations; and (3) Federal, State, and local tax policies with respect to their effect on land and property costs and on incentives to build new housing and make improvements in existing structures: It is recommended that the proposed study be accomplished through the voluntary participation of learned societies and trade and professional associations utilizing the vast body of information available in the respective fields of study, and that the request be reduced to a level believed sufficient to cover research study coordinating costs and printing of reports.

Natural disaster study:

Budget request	$600,000
Recommended reduction	600,000

A study of alternative methods of providing financial assistance to those suffering losses through floods or other natural disasters was authorized by the Southeast Hurricane Disaster Relief Act of 1965. For this study purpose, the fiscal 1966 budget carries new obligational authority in the amount of $1 million, and the budget for 1967 proposes an additional $600,000. It is recommended that this 1967 request be eliminated pending review of the results of the first $1 million expenditure.

Community development training programs:

Budget request	$5,150,000
Recommended reduction	5,150,000

These programs, authorized by the Housing Act of 1964 have never been funded. If funds were provided, the programs would inject the Federal Government into training State, county, and local municipal employees. For this reason, it is recommended that this budget request be refused in its entirety.

Urban planning grants:

Budget request	$35,000,000
Recommended reduction	10,000,000

This program provides Federal grants (generally two-thirds of costs, and in certain cases three-fourths of costs) for comprehensive urban planning and for developing solutions to metropolitan or regional problems. Appropriations for this purpose are authorized by housing laws, and under this program the Department (on the basis of appropriations) obligates itself to pay grants on account of specific State and local operations. Because the evidence presented in recent budgets and the current budget does not seem to be sufficient to justify the substantial increase requested on this account, a reduction to $25 million is recommended.

Grants for basic water and sewer facilities:

Budget request	$100,000,000
Recommended reduction	100,000,000

Under the provisions of the Housing and Urban Development Act of 1965, this program of 50-percent grants (with some minor exceptions) to local public agencies for water and sewer facilities was established. Since the program would provide special benefits to a few communities at the expense of the rest of the Nation, and since there are abundant financing devices already available (including both regular market sources and Government programs, such as the public facilities loan program), it is recommended that this request be refused in its entirety.

Grants to aid advance acquisition of land:

Budget request	$5,000,000
Recommended reduction	5,000,000

Under this program (authorized by the Housing and Urban Development Act of 1965) the Federal Government pays the interest of loans floated by local governments to finance land acquisitions. Since this program injects the Federal Government into local land dealings (and into the local programs for facilities to be built on such land, since there is a construction time requirement), and since the effect of this program would be to create additional demand pressure on land prices, it is recommended that this request be refused in its entirety.

Open space land and urban beautification:

Budget request	$935,000
Recommended reduction	460,000

This request relates to administrative expenses of the Federal program of grants for open space land and urban beautification, and represents an increase of more than 95 percent above estimated costs for the current year. Such an increase in administrative expense cannot be justified in terms of increases in grant payments and obligations (expected to rise about 75 percent in the budget year) since the grant payments and obligations increase will be the result of an increase in the percentage of Federal grant (from 20 to 30 percent of costs, currently, to 50 percent of costs). For this reason, it is recommended that the request be reduced to a level approximating that of the current year.

Grants for neighborhood facilities:

Budget request	$25,000,000
Recommended reduction	25,000,000

Under this program, established by the Housing and Urban Development Act of 1965, the Federal Government pays two-thirds (and, in certain cases, three-fourths) of the cost of recreational, health, community service, or social facilities. The program injects the Federal Government into local and neighborhood programs, and provides special benefits to a few communities at the expense of the many, and, for these reasons, it is recommended that this request be refused in its entirety.

Rent supplement program:

Budget request	$3,000,000
Recommended reduction	3,000,000

This request is for funds to start up the rent supplement program which was contained in the Housing and Urban Development Act of 1965 but which was not funded by the Congress. Since the costs of rentals are only one aspect of the welfare problem in alleviating distress of unfortunate families, and since welfare problems are best handled by local levels of government, it is recommended that this request be refused in its entirety.

City demonstration grants:

Budget request	$12,000,000
Recommended reduction	12,000,000

This request relates to a proposal for subsidies of 80 percent of non-Federal costs of programs of individual cities demonstrating ways to tie together a multiplicity of Federal subsidy programs and local activities in efforts to stir city improvement. However, lasting solutions to city problems cannot be expected to come from continuing and growing infusions of Federal funds, but must come from self-generating and regenerating activities organized by local leaders and operated in a climate of incentives conducive to progress. For this reason, it is recommended that this request be refused in its entirety.

Urban renewal programs:	
Budget request:	
For salaries and expenses	$15,625,000
For subsidies	725,000,000
Recommended Reductions:	
For salaries and expenses	2,000,000
For subsidies	725,000,000

Under the urban renewal program, Federal Government subsidies cover two-thirds (and sometimes three-fourths) of the local renewal agencies' losses which arise, predominantly, because property in renewal areas is resold for less than the costs of acquiring it and preparing it for resale. These continuing losses, which evidence a serious mismatch between the projects and the types of development actually in public demand (which people want and are willing to pay for), indicate the need for a major change in urban renewal toward a system in which full project costs will be recouped out of new values created in project areas. For this reason, it is recommended that the budget request for funds to subsidize continuing losses be rejected in its entirety, and that the request for funds for salaries and expenses be reduced to a level sufficient to handle the remaining expenses related to subsidy commitments which have been made in the past.

Housing for the elderly or handicapped fund:	
Budget request	$80,000,000
Recommended reduction	80,000,000

Under this program, which was established by the Housing Act of 1959, the Federal Government makes direct loans at sub-market rates of interest to public agencies and nonprofit organizations for providing housing to rent to the elderly and the handicapped. Since this involves Government intrusion into lending, and since the program provides special advantages to a few of the elderly and the handicapped at a cost to the large majority and to other citizens, it is recommended that this request be denied in its entirety.

Federal National Mortgage Association (special assistance functions):	
Budget requests: for new loan (authorization, becoming available under existing legislation, to spend public debt receipts)	$450,000,000
Recommended reduction for new loans	450,000,000

Under this program, the Federal Government makes direct mortgage loans at submarket rates of interest from the proceeds of public debt receipts (backdoor spending). Because this is a direct lending program, and because it is operated in a manner bypassing the appropriations processes of the Congress, it is recommended that this authorization be rescinded.

Federal Housing Administration (administrative expenses, rent supplement program):	
Budget requests	$1,030,000
Recommended reductions	1,030,000

This request is for funds to cover the administrative expenses of the rent supplement program which was contained in the Housing and Urban Development Act of 1965. Since it has been recommended (above) that the funds for the rent supplement payments not be provided, it is also recommended that the request for funds for administration of the program also be refused.

Public housing programs (administrative expenses):	
Budget request	$20,223,000
Recommended reduction	2,818,000

Administrative expenses of the low-rent public housing program result from the provision of technical advice and assistance to local housing authorities in the development and management of projects and from auditing activities. The fiscal 1967 budget request is for an amount more than 15 percent in excess of that for the current year. Such an increase, however, runs counter to announced emphasis on private enterprise development of projects, on greater local agency roles in public housing determinations, and on programs directed toward the total welfare of persons rather than toward only one symptom of distress. For these reasons, a reduction to an expenditure level approximating that of the current year is recommended.

Department of the Interior

Office of Saline Water (salaries and expenses):

Budget request	$28,595,000
Recommended reduction	5,000,000

Current requests amount to a 43-percent increase over the 1966 appropriation. In view of the sizable increase in the program last year, it would appear that a continued buildup of expenditure for contract research would lack foresight until some particular evaluation can be made to determine how fast and in what direction saline water research should take.

Department of Labor

Bureau of Employment Security (limitation on grants to States for unemployment compensation and employment service administration trust fund):

Budget request (limitation)	$508,950,000
Recommended reduction	24,870,000

Employment Service activities for fiscal year 1967 are programed at a $248,705,000 level. Employment Service appropriations in fiscal 1964 and 1965 were predicted in part on estimated projected job placements 10 percent and 9 percent higher than actual job placements made.

In 3 consecutive years the Employment Service has requested and received its appropriation based on placement estimates which averaged 10 percent more than those actually made. Appropriations for the Employment Service activities should be reduced by 10 percent or $24,870,000.

Wage and Hour Division:

Budget request	$22,256,000
Recommended reduction	754,000

The Division's requested appropriation is above last year's with the increase caused primarily by the assumption of administrative functions under the new Service Contracts Act of 1965. Since the same staff performs the same duties in administering the Walsh-Healey Act, a substantial reduction in proposed increases is recommended.

Bureau of International Labor Affairs:

Budget request	$1,230,000
Recommended reduction	23,000

The Bureau has requested an increase of $11,000 for the coming fiscal year. However, $23,000 is budgeted for an increase of two new positions with responsibility for furnishing information on international trade unions. These additions are unnecessary in that the International Labor Organization in Geneva, supported by our Government to the extent of approximately 25 percent of its total budget, already performs this function.

Office of the Solicitor:

Budget request	$5,451,000
Recommended reduction	206,000

While the overall budget request by this office is somewhat lower than in fiscal year 1966, funds for field operations have increased by $198,000. Better coordination and utilization between central office and field staff should eliminate the need for this sum. At the same time, the appropiration of an additional $8,000 for determining prevailing wage rates and fringe benefits in construction contracts is not justified in light of the absence of any increased responsibilities in this area.

Office of the Secretary:

Budget request	$4,701.000
Recommended reduction	115,000

The Office of the Assistant Secretary for Administration has requested a $59,000 increase for employee health programs to promote physical and mental fitness. This would mean a per capita rate of $15 per employee, an exorbitant sum on a mass scale, and one that should not be granted.

The Office of the Director of Federal Contract Compliance seeks the addition of three new permanent positions. Considering that the Federal Government's departments and agencies are now initiating the use of their own contract compliance officers to eliminate discrimination in hiring, the requested increases are unnecessary. Duplication of personnel would also be avoided by disallowing an added $21,000 for consultants "requiring specialized, high-level talent" a supposedly existent virtue in the Contract Compliance Office at the present time.

Atomic Energy Commission

Operating expenses:

Budget request	$1,985,000,000
Recommended reduction	37,400,000

The Chamber proposes a reduction of $37,400,000 in the 1967 request, holding the Physical Research program at the same dollar level as fiscal 1966; avoiding any increase in personnel; eliminating the educational grants portion of the Training, Education, and Information program; and reducing the funds for Biology and Medicine to the 1966 level.

Funds for physical research should be reduced for on-going programs not essential to the national defense effort, with the possible exception of new funds needed to bring into operation the newly completed Stanford linear accelerator.

Additional personnel in excess of current levels should be held down, at least until the period of heavy outlays for war is ended.

Fellowship and traineeship grants to individuals and institutions for research use at universities and at AEC laboratories should be terminated completely, and such education and training aids as may be justified should be administered by the National Science Foundation under a single well-coordinated program. Reduction in Biology and Medicine involves largely holding down on in-house research programs.

General Services Administration

Construction, public building projects:

Budget request	$170,277,000
Recommended reduction	70,000,000

The funds requested are $30.5 million more than was made available for fiscal year 1966 and include $92 million for 32 new projects.

The known heavy funding requirements for Vietnam operations and the uncertainty of such demands in the future coupled with the acknowledged inflationary pressures already existing, call for utmost restraint in the construction of new buildings for housing routine Government operations. Because the establishment of priorities for such construction is largely discretionary, a cut of $70 million will not unduly interfere with the essential functions of Government.

Other independent agencies

Commission on Civil Rights:

Budget request	$2,703,000
Recommended reduction	1,000,000

The total increase in requested appropriations by the Commission for the coming fiscal year amounts to $1,190,000. This figure represents a total across-the-board increase in almost every category of operations with many exceeding 100 percent. A reduction of $1 million is appropriate in light of the recent reorganization of various civil rights functions within the executive branch and the expansion of programs by the Departments of Labor, Commerce, Justice, and others that coincide with the work done by the Commission.

Equal Employment Opportunity Commission:

Budget request	$5,870,000
Recommended reduction	2,000,000

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Due to the large volume of complaints filed in the first 6 months of the Commission's operations, fiscal year year 1967 requests aggregate an increase of $2,378,000 over fiscal 1966. Much of affirmative action programs encouraging equality in employment that would be undertaken by the EEOC in utilizing new appropriations, are now capably being carried out by the voluntary Plans for Progress organization.

Additionally, the Commission's proposed budget item of $900,000 for State administration is far too high in light of the amount of revenues now being expended at the State and local level in administering existing fair employment laws.

The proposed extensive increase in personnel strength should be partially deferred for the present until sufficient time elapses in which to judge the adequacy of the Commission's utilization of its staff.

Federal Power Commission (salaries and expenses):

Budget request	$14,288,000
Recommended reduction	550,000

The FPC has had significant personnel increases annually since fiscal year 1961 when it had 851 employees, currently FPC has 1,152. In view of the stable workload and completion of a major project, the addition of 55 more employees is not warranted.

National Capital Planning Commission (salaries and expenses):

Budget request	$1,144,000
Recommended reduction	326,000

The Planning Commission is the official planning agency for the District of Columbia and the Federal Government in the National Capital region, developing and maintaining a long-range plan for the area, and reviewing building developments and land acquisitions of Federal agencies. The Commission's workload, as presented in the budget, does not seem to justify a more than 25-percent increase in personnel and in appropriations.

National Labor Relations Board:

Budget request	$30,442,000
Recommended reduction	2,339,000

The NLRB's request for increased appropriations is undoubtedly due to a rising caseload. The NLRB, however, has minimized the cause of this increase, which has been due in a large part to its decisions favoring labor union officials. The NLRB's rulings concerning bargaining, for example, have encouraged labor officials to file charges in the hope of securing from employers concessions which they have been unable to gain at the bargaining table. Similarly, NLRB decisions on bargaining units and its inclination to find employer conduct objectionable has been based on a philosophy of encouraging union organization. This obviously invites union officials to turn to the NLRB for assistance in their organizing drives.

There is a trend, nevertheless, to an increase in cases and the NLRB is expected to return to Congress each year for more funds. The problem, as noted, is largely due to the NLRB's own machinations which they show no signs of changing. The problem can therefore be corrected only by abolishing the NLRB and transferring its authority to a labor court or to Federal courts of general jurisdiction.

Tennessee Valley Authority:

Budget request	$63,635,000
Recommended reduction	14,841,000

The recommended reduction consists of a reduction of $11,010,000 in capital funding for the acquisition of additional lands for the Between the Lakes Recreation Area and $3,831,000 in operating funds for the Cooperative Valley development program. Responsibility and funding of these activities should be through more appropriate existing agencies, thereby reducing duplication. The land and water conservation fund should be utilized for purchase of land for recreation areas.

Representative GRIFFITHS. How much do you think it should be cut now?

Mr. MADDEN. I think the correct answer to that is implicit in the testimony that the budget should be cut sufficiently to achieve a small surplus in fiscal 1966.

Representative GRIFFITHS. What items do you think should be cut from the budget that benefit the business members of the Chamber of Commerce?

Mr. MADDEN. I would not be able to say. However, I do not believe that the issue that the Congress should consider is whether items in the budget benefit one group or another but, rather, which items in the budget are more essential to the public interest and which are less essential.

Representative GRIFFITHS. Would you say roughly that those items should be left in if by casting them out you would do the most long-run harm to the Nation?

Mr. MADDEN. That certainly would be a reasonable consideration. However, I would like to repeat that this is a problem which it seems to me is the responsibility of the Congress.

Representative GRIFFITHS. I think that you are quite right, but I still think if you come in and ask for a fiscal restraint other than a tax increase that you have some obligation to name the items you think should be cut from the budget.

Mr. MADDEN. I can give you some examples under the general cautionary qualification that I have already stated. One of these in the judgment of the chamber the antipoverty program appropriation. The chamber's view in the connection is shared by Dr. Paul Samuelson of MIT as he stated his view on February 9 at the symposium referred to. As he pointed out, the antipoverty program, insofar as poverty is alleviated through increased employment, is made less necessary by the very increase in employment that accompanies the boom.

Representative GRIFFITHS. Is not one of the problems now, and do you not mention it, that as unskilled people are brought into the labor force the productivity of the labor force is declining? Would you not say therefore that one of the really essential things is that the labor force be upgraded and better trained?

Mr. MADDEN. I would agree, yes, but I do not think that vitiates the thrust of the argument favoring the antipoverty appropriation, because I believe it is correct that the largest portion of the expenditures of the antipoverty administration, the Office of Economic Opportunity, lie elsewhere.

Representative GRIFFITHS. At least as to this part of it you certainly would not be willing to cut out the upgrading of the labor force?

Mr. MADDEN. That is correct.

Representative GRIFFITHS. You would have to have that?

Mr. MADDEN. That is correct.

Representative GRIFFITHS. Those expenditures that are expenditures for education that more fully qualify the labor force are not cuts to be made now. Those things should not be cut out.

Mr. MADDEN. Insofar as these training programs are effective, I would agree with that position.

I do think, however, that we have an obligation to ask the question about the effectiveness of training programs such as those in the antipoverty administration.

There are examples here that could be brought to bear. I will not, however, pursue the subject.

Representative GRIFFITHS. From your paper, do I understand that it is your judgment that when the economy is to be stimulated that tax cuts are in order?

Mr. MADDEN. Yes.

Representative GRIFFITHS. But when the economy is to be restrained, then governmental programs are to be removed from the budget? Would you always do that? Would there never be a time when you would say that the taxes should be increased?

Mr. MADDEN. Our position is not based on an absolute and abstract judgment such as you suggest. It is based on the view that historically as the result of the war-time conditions that have existed since the 1940's tax rates are in fact too high, and it is also based on the judgment that, as the result of the cold-war effort which challenges the will and determination of the United States and its Government, in view of high tax rates, it is more prudent and more mature and more fiscally responsible to postpone less essential governmental expenditure programs or such programs which are judged by some elements of the public as being misdirected or ill-designed or mismanaged than it would be to increase tax rates which fall upon the whole country.

Representative GRIFFITHS. Do you not then believe at the present time the cutting back of programs would operate too slowly to restrain the economy?

Mr. MADDEN. No; I do not believe that cutbacks would operate too slowly to restrain the economy.

Representative GRIFFITHS. I think we continue to come to the question, Which are the programs that we could cut back quickly? Is the chamber of commerce willing to cut back the roadbuilding program?

Mr. MADDEN. I think no program in the domestic sector should be inviolable from the scrutiny as to making judgments of priorities in spending proposals. It seems to the chamber of commerce as a national federation that if ever there was a time for maturity and self-discipline in maintaining our record expansion it is in 1966. We agree in this sense with Walter Lippmann:

> That all of this has to do with something that has never been done before; that is, to regulate a boom so there is no crash but, on the contrary, a sustained prosperity without inflation. In the history of modern states, this is a momentous and thrilling experiment—this attempt to show that by deliberation and choice a nation can master the violence of the business cycle. Next to the prevention of war, there is no more critical task with which modern governments have to deal.

Representative GRIFFITHS. I agree that it is right but I return to the question that I think it would be practically impossible to select the programs now on which you are going to apply the brakes and have the brakes apply fast enough to stop the inflation.

Mr. MADDEN. This is where we disagree.

Representative GRIFFITHS. Senator Proxmire?

Senator PROXMIRE. I understand you have a list of some 51 cuts that you recommend?

Mr. MADDEN. We agreed to furnish this list to the committee.

Senator PROXMIRE. You do not have it available at the moment?

Mr. MADDEN. I do not have it with me.

(See pp. 146–156, preceding.)

Senator PROXMIRE. Could you give us four or five of the leading ones? I do not mean to badger you on this because I agree we should cut and I think there are places we should cut.

Mr. MADDEN. One I mentioned is the area of the antipoverty program. A second area is in foreign aid—I would have to check.

Senator PROXMIRE. As far as the antipoverty program, I would disagree with your assertion that OEO is not very largely confined to education and training. Community action program is designed primarily to help people who are illiterate to become literate at least to some extent so they can qualify to hold jobs. The whole Job Corps program is designed for this. Even something as remote in time at least from employment is the Headstart program which concentrates on a preschool program. This is to help children acquire a little greater ability so they can take advantage of education to a greater extent.

Would you cut out the Headstart program or cut it down?

Mr. MADDEN. No, we would not. If I may reply to your comment, first, before the antipoverty program got underway it is our understanding that the United States was spending more on measures directly or indirectly to alleviate poverty than on any other single purpose except national defense.

Senator PROXMIRE. More than we spend on servicing the national debt?

Mr. MADDEN. Yes.

Senator PROXMIRE. More than $12 billion?

Mr. MADDEN. Yes. The Catholic Coordinating Committee on Anti-Poverty Efforts in 1964 estimated that we were expending in excess of $30 billion.

Senator PROXMIRE. You are not talking about the Federal Government?

Mr. MADDEN. I am talking about the Federal Government alone.

Senator PROXMIRE. Would you include then social security payments?

Mr. MADDEN. Certainly an important part of the poor are the aged poor and I would include social security payments.

Senator PROXMIRE. That is a program they contributed to when they were working. It is a program that the experts tell us is actuarially sound. Lately we have started to flirt in the Prouty amendment, which in my judgment is a less responsible way of handling this, but in the past it has been based on a tax which is supposed to be directly related to the benefits received. You would consider at least part of that program to alleviate poverty?

Mr. MADDEN. I would.

Senator PROXMIRE. On that score, do you not recognize that in this the OEO thrust is different from the Roosevelt approach? That was a program which occurred at a time when the private sector of the economy was in dire straits. There was heavy unemployment, and somehow we had to find jobs for a very great many, recognizing that jobs are better for people than straight relief. This is not that type of program. The free enterprise is booming and people are needed to fill jobs. It seems to me this program is trying to do something which is much more satisfactory as far as the poor are concerned. It puts them in a position where through hard work they can develop enough skill, training, and education so they can go out and work. I should think the chamber of commerce would be cheering this on. It is no "handout." Training or education that is worth anything is acquired through effort. You have to earn it in the toughest kind of way; and it is especially tough for people who are illiterate, or a little older than most who would usually be involved in education or training programs. Why is this not in the best tradition of American self-reliance and opportunity rather than in the "give away" sense which you seem to imply by saying this is the kind of thing you can dispense with?

Mr. MADDEN. The chamber of commerce, Senator Proxmire, has a task force on economic growth and opportunity of 100 or more chief executives of industry who are studying the long-range poverty question.

We have commissioned over 30 academic papers from independent experts and have consulted more than 150 experts in the field of poverty, welfare, medical care, philanthropy, and other related areas.

The task force on economic growth and opportunity has published two studies, one, "The Concept of Poverty," and, second, "Poverty: the Sick, Disabled, and Aged."

In the first study, "The Concept of Poverty," the task force recognized the extreme importance of the objective of minimizing poverty in the United States. It proposed a definition of "poverty" which was at about the time of the publication of the report adopted in part by the Office of Economic Opportunity.

It took the position that you describe; that insofar as people have the capacity to climb out of poverty, that opportunity was a means by which, in the tradition of the American system, this should be done.

The national chamber, however, is cognizant of the criticisms which have been brought to bear against antipoverty programs by observers as far removed from one another as Saul Alinsky, the professional radical, and Fortune magazine, which describes the war on poverty as "a mixed-up war on poverty."

We have been aware that the costs of the Job Corps, according to testimony before the Congress, ranged from $8,000 per Job Corps man per year up to the sum reported in the newspaper of $14,000 per Job Corps man per year in the Tongue Point Job Corps Center in Oregon, according to the testimony of witnesses before a congressional committee. This to us seems to suggest that we need a thoroughgoing investigation of the antipoverty effort as it is represented by the Office of Economic Opportunity, although at the same time we recognize the importance of alleviating poverty.

One more point: A book published by Ben J. Wattenberg and Richard M. Scanlon called, "This U.S.A.," points out that we have achieved considerable progress against poverty since World War II. They point out this fact in great detail, which I will not go into.

However, their view agrees with the view of Eugene Smolensky, professor of economics at the University of Chicago who wrote a paper that is included in the "Concept of Poverty."

Smolensky did an empirical study of progress against poverty and found in the 20th century we had made the greatest progress in alleviating poverty during periods of high employment, stable prices, and rapid growth. Thus we agree completely with you, Senator Proxmire, in the importance of alleviating poverty.

Our disagreement, insofar as there may be one, is over the question of means; and we raise the question for the consideration of the Congress as to whether the time may not have come for a careful investigation of the success and the results of the antipoverty program in the light of the known beneficial effects of rapid economic growth, stable prices, and high employment in the economy.

Senator PROXMIRE. I would agree wholeheartedly with you that it should be investigated. I agree there are many examples of mistakes, and I agree we should correct them as promptly as possible. The Congress and the administration are working hard on this and we have a superb man heading it up—Sargent Shriver—but in any program as big and as ambitious as this, which involves a billion and a half dollars or more, there are bound to be some very big and graphic examples of waste. The Wall Street Journal made its own investigation and certainly we would say that is a reliable and honest publication. They found even the dropouts from the Job Corps are far better and greatly improved after they had an opportunity to be in the Job Corps. Those who stay in and finish, after a few months, have a lifetime ahead of good, productive work in being employed and not alternating between relief, odd jobs, unemployment compensation, and so forth. So even if it does occasionally cost more than a few thousand overall it is not likely to be excessive.

If you can take a person who is on relief and who is a "tax eater," and is going to be that all his life, and convert him into a person who helps us fulfill the very serious labor shortage we have today, think what a remarkable contribution this is to the economy.

At any rate, I am inclined to agree that it should be investigated, but it would seem to me that any cut that would mean anything, for instance, if we cut the antipoverty program from a billion and a half back to a billion, it would seem to me we are going to have tens of thousands of people who would continue to be on relief, continue to be out of work, nothing but a liability throughout most of their lives, whereas they could be converted into useful, skilled, happy taxpayers. That is, if any taxpayer can be happy.

Mr. MADDEN. I think the question is exactly this: In view of at least some important element of the population, every Government program is desirable. We economists speak of the scarcity of means as compared with human wants. Certainly this applies with respect to desirable Government programs. It seems to us, however, that the issue is one of choosing and setting priorities with respect to programs in this particular year and in the light of this difficult problem, which indeed is a difficult problem, we must make hard choices as to how fast to go and as to how effective our past efforts have been with respect to every Government program.

Senator PROXMIRE. I would agree on that. Let me interrupt, and I apologize for interrupting, because I know you have a little more to add, but before it gets away from me, it seems to me there are other programs such as the public works program which is very hard for Congress to get at because of the nature of Congress, the pork barrel, public works programs, where we have a very low benefit-to-cost ratio with a phony discount figure which we still use of around less than 3 percent when the interest rate is running around 5 percent; where we permit a 100-year lifespan in the dam that is being built; where we insist on counting as a plus for the society bringing into production more farmland when we are spending hundreds of millions of dollars to take land out of production. Why should not the chamber of commerce seriously recommend a cutback here? I think this could have real impact. I think we could say very promptly the President does not have to go to Congress to do it. He could simply refuse to spend money, as he has done in some areas.

This, it seems to me, would be more helpful in an inflationary situation than any kind of proposal that we cut back our training programs and any kind of a training program, even a Headstart program or any other kind of opportunity.

Mr. MADDEN. Including an unsuccessful training program?

Senator PROXMIRE. I agree we should investigate unsuccessful ones but we should investigate first and then cut rather than propose that we can save a substantial amount of money in a billion and a half dollar program without investigating first.

Mr. MADDEN. I think I can say the chamber of commerce would applaud your efforts to achieve reductions in public works programs in which the cost exceeds the benefit.

Senator PROXMIRE. Let us get some new rules on the way we figure the benefits and the costs.

You say we should cut foreign aid. Here, again, it seems to me that, in the long run, much of our foreign aid money can be considered to be a pretty good investment for the taxpayer. It is always an easy thing to attack because it has no constituents like some of these other programs, but our foreign aid—certainly in Vietnam, and I am talking about the economic part of our effort in Vietnam—it seems to me you can make a strong effort to increase it and improve it. Our land reform effort has been virtually nil, and if we are going to win the support of the South Vietnam people we need more technical assistance, a step-up in the Food for Peace program—all of these things seem to be very helpful in creating the kind of world in which we can have peace and freedom without the perfectly enormous expenditures, let alone the fakers and the risks involved in the kind of military effort that is now necessary, in my judgment, in Vietnam.

So where would you cut the foreign aid?

Mr. MADDEN. Again I think our position is we bow to the wisdom of Congress cutting the budget. The principal point of the testimony is that the budget should be cut and expenditures should be cut. We would defer to the wisdom of the Congress in cutting these expenditures, but for fiscal policy purposes we urge expenditure cuts rather than tax increases.

We recognize in this connection that it is difficult to explain to taxpayers who have just experienced a $6 billion tax package increase or perhaps not increase but certainly change only a few weeks ago, why it is necessary to propose and institute another tax increase 1 year after a tax reduction has been made of reduced excise taxes which were purported to be to stimulate consumption.

We think that this confusion which results from constant jiggering of the tax structure is far more difficult to explain to voters and has a far broader impact on voters in general and citizens in general than reductions in programs which have received great public attention as being deserving of investigation and rescrutiny.

Senator PROXMIRE. I am delighted that you recommend that we do not increase taxes. I am one of the few members of this committee who is not in favor of a tax increase, and I am particularly against an investment credit removal. Originally I voted against the investment credit. I was wrong. It has proved to be an excellent stimulus for plant and equipment. I think if we remove the uncertainty which is an important aspect of this investment credit it is a fine incentive.

I am glad you took that position. Many other witnesses here have taken a contrary position.

Mr. MADDEN. We heartily recognize your position here and not only does it fail to dampen inflationary pressures, as you said, because of the long leadtime between the order and delivery of productive equipment, but furthermore we have checked official sources to find out that there would be a very small revenue increase in 1966.

Senator PROXMIRE. What is your estimate?

We had an estimate from the Treasury.

Mr. MADDEN. Our estimate in the fiscal year 1967, the tax yield from removing the investment tax credit would be less than $1 billion and that in this year it would be even less than that so the major impact of the removal of the investment tax credit would occur in fiscal year 1968.

Senator PROXMIRE. Of course, the argument that those who would remove it make is not that removal would yield a great deal of money but it would end what they consider to be an inflationary element, the acceleration caused by a sharp increase in business investment.

Mr. MADDEN. We recognize your own argument against this leadtime for planning of corporate investments, but we also recognize the findings of the fourth annual manpower report which points out that the increase in the labor force from the years 1966 to 1970 is expected to be 1½ million per year, which is 50 percent greater than the rate of increase in the labor force for the past 5 years and nearly double the rate of increase of the 1950's, and we, like you, are deeply concerned about maintaining stable prosperity and increasing the skills and productivity of the labor force.

We are particularly cognizant of many institutional restrictions that bear upon the employability of young, unskilled and inexperienced members of the labor force, and we therefore feel that the investment tax credit which does indeed increase the rate of improvement of our technology and increase the productivity of our economy is a vital, permanent feature of the tax system to maintain the rate of growth necessary to yield employment in the services industries and elsewhere that will be suitable for the qualifications of these young people coming onto the labor force.

Representative GRIFFITHS. May I ask you, is it not possible that the investment tax credit is making more necessary upgrading of the skill of employees?

Mr. MADDEN. I do not think that necessarily follows, Madam Chairman. It may follow with respect to manufacturing employment but it does not necessarily follow with respect to services employment. The fact of the matter is that the growth in the employment in the services sector of the economy has been most rapid of any sector in the last few years.

As you well know, more than half of our labor force is now employed in services. There is wide agreement among business economists that the opportunities for employment in the services industry have not yet been nearly fully exploited.

Therefore, although it may well be that in manufacturing the investment tax credit may increase the demands for skills, it does not necessarily follow from this that it would increase the skilled requirements for the labor force.

Representative GRIFFITHS. Does the chamber of commerce have a position on when you would recommend a tax increase?

Mr. MADDEN. Certainly the chamber of commerce would not take the position that no tax increase is ever appropriate. We are addressing ourselves to the current situation in the recognition that this is a test of the maturity and discipline of the American Government and the American people, and we recognize the crucial difficulty for the administration and the Congress in this fifth year of an astonishingly productive economic expansion and in this election year when the choices before the Congress are so harsh and difficult.

Representative GRIFFITHS. This committee is not interested in this year alone. We are interested in whether or not tax increases and decreases should be used as a means of stimulating the economy and slowing it up.

Are you saying that your position is that a tax increase should never be used to slow the economy?

Mr. MADDEN. No; that is not our position.

Representative GRIFFITHS. Under what circumstances would you use it?

Mr. MADDEN. I would find it difficult to answer the question "off the cuff." As it has been said, this is a somewhat "iffy" question. I do not mean to be disrespectful.

Representative GRIFFITHS. If you would find that you would use a tax increase to slow up the economy, what kind of tax increase would you use and what would you say would trigger your use of it?

That is what we really need to know.

Mr. MADDEN. I do not believe I am in a position to concoct the hypothetical circumstances under which a tax increase would be appropriate.

Senator PROXMIRE. Would the chairman yield at that point?

Representative GRIFFITHS. I yield.

Senator PROXMIRE. Suppose we had a very, very serious step-up in the Vietnamese war, say a war with China, and we had to increase enormously our military expenditures. Would the chamber of commerce position be that we should borrow the money or should we then increase taxes?

Mr. MADDEN. I think the chamber may well feel that a tax increase is necessary to raise revenue to finance the war. However, that is not what I interpreted the question to mean.

Senator PROXMIRE. This type of hypothetical situation could develop. We hope and pray and expect it won't but if it were to occur would you advocate an added increase in income tax, or a value-added tax, or what would be your view?

Mr. MADDEN. I think we would advocate that whatever tax would be necessary under some such circumstance should be immediate, and certain and neutral with respect to the tax structure. That would lead us, I believe, to favor an increase in the individual income tax over an increase in taxes which itself might contribute to price rises such as an increase in the corporation income tax or in excise taxes.

Senator PROXMIRE. That is fine. In other words, you feel everybody should be treated alike so you would have an equal percent increase in the income tax? There would not be a basis for one group saying that their increase was higher than that of another group?

Mr. MADDEN. Exactly. Under such circumstances we feel it would be inappropriate to attempt to reform the tax structure. That would be self-defeating.

Representative GRIFFITHS. I agree.

Senator PROXMIRE. You have said here today, "proposals to increase minimum wages, to increase unemployment compensation taxes and to add to the costs of credit and consumer items by cost-raising regulation deserve careful scrutiny."

Our experience with increasing minimum wages has been pretty substantial. We increased minimum hourly wages from $0.25 to $0.40 to $0.75 to $1.25. I have not been aware of any analysis that has related those increases to any inflation. I have constantly asked economists on this committee if they could document it one way or the other. They couldn't.

Do you know of any evidence that proves this would be the case?

Mr. MADDEN. May I defer an answer to that question and if I do know of such evidence, present it to this committee?

Senator PROXMIRE. I would appreciate that answer. Also, on unemployment compensation taxes.

Mr. MADDEN. It certainly can be reasoned as follows for your consideration that if the minimum wage in 1966 is raised from $1.25 to $1.40, a 12-percent increase, that with a surging demand for labor which we now have, it is likely that the differentials between the minimum wage and the rest of the wage structure would be restored more rapidly than such differentials would be restored if the economy were underemployed.

If the differentials were restored quickly and if, as industry leaders tell us, these differentials would have to be, by and large, maintained, then it would follow that the increase in the wage structure would be likely to exceed the guideposts of 3.2 percent advocated by the administration.

Furthermore, it can also be reasoned that if in its legislative policy the administration encourages the view that wages might be raised in excess of the guideposts this might well create a psychology among workers and consumers to lead them to anticipate further rises in prices.

Such an inflationary psychology in itself, it can be argued, contributes to the instability which this committee is attempting to avoid.

Senator PROXMIRE. At the same time, there are counteracting elements, are there not? In other words, it is conceivable as you increase the minimum wage you get more production from the worker. That is one possibility and I know of instances where this seems to have been true. It is also true as you increase the wage you provide an incentive for automation, the substitution of equipment for labor.

Some people consider it perverse but I consider it a progressive consequence of increasing wages.

It is especially true of people with small wages. These are the routine jobs which in many cases can be computerized or automated and can be eliminated. At the same time, as long as you upgrade the skills of the people sufficiently, it is conceivable that this kind of thing could result in an increase in productivity and a lesser increase in prices than you might otherwise expect.

Certainly if your reasoning were followed through completely we would have had a record of very sharp increases in the price level at least at some times in the past when we have increased it, although I think it is a very interesting and provocative context you put it in.

You point out we would now be increasing minimum wages at a time of scarcity.

Mr. MADDEN. Furthermore, I am sure you would agree that it depends not only on the fiscal policy at the time the minimum wage was raised but also on the state of the economic activity related to capacity as you just said.

Senator PROXMIRE. I have one other area I would like to ask you some questions about. You say that a rise of prices following stability from 1958 through 1964, yet the Consumer Price Index, at least, has been performing reasonably well; and in 1965 it went up less than 2 percent, and four-tenths of a percent in January. It did not go up at all in February. Maybe it is going to go up in the future, we don't know.

At least one competent economist has called it a phantom inflation. I wonder if, maybe, we are not anticipating too much or fear too much here.

Mr. MADDEN. Arthur Burns in the symposium on February 9 pointed out that beginning in mid-1964 the Wholesale Price Index—which is the broadest measure of prices we have—began to rise after an 8-year period of stability, and he pointed out that in the last 12 months ending in January this index rose 3.4 percent.

Senator PROXMIRE. It is also expected to rise sharply this month.

Mr. MADDEN. He also pointed out from his studies of the business cycles, and he is an authority on this subject, it is characteristic that the Consumer Price Index rises with a lag after the Wholesale Price Index has risen. It is on this basis that I believe most business economists anticipate a further rise in the Consumer Price Index this year at a more rapid rate than last year.

They also recognize, of course, that there is in the Consumer Price Index, a technical difficulty in measuring improvements in quality. However, despite that technical difficulty, I think it is true that rises in the Consumer Price Index have their severest incidence upon the incomes of the least fortunate citizens of the United States who consume a larger portion of their small income than those better situated, so while we in the chamber of commerce share your concern about the issue of poverty, we also recognize that inflation is an invisible tax which falls perhaps with heaviest incidence upon the very poor people about whom we are all concerned.

Senator PROXMIRE. No. 1, as far as the Wholesale Price Index leading the Consumer Price Index, I wish it had led the Consumer Price Index for the last 8 years in that the Wholesale Price Index has been stable and the Consumer Price Index has not been steady. It has risen.

You can also argue that farm products have been underpriced for a long time inasmuch as the farmer enormously increased his productivity and his investment and his net income has not been going up at all until very recently.

There is a little catching up on his part. You might say the same thing about mining and some metals which would go into the Wholesale Price Index.

I am interested in your statement here where you say, "productivity gains are tapering off."

We had testimony from the Secretary of Labor and the Commissioner of Labor Statistics that they were anticipating a modest reduction in productivity but they expected it to be in the area of a 3-percent increase or 3.2. That is why they have tied their wage-price guideline index to the 3.2.

Do you question that? Do you think that is too optimistic?

Mr. MADDEN. My understanding from this same symposium on February 9 was that the productivity increase last year, insofar as it can be measured with any great accuracy in a single year, was by 2.8 percent, which was below the long-range trend.

So, to anticipate an increase in productivity this year would be to assert that the direction of productivity will reverse itself in a year in which we have closer to capacity operations than any year during this record expansion.

Senator PROXMIRE. There are two reasons why there might be one. One is that there has been such a rapid expansion in investment of plant equipment, much of which is automated equipment which would make automation more widespread and there has been a great deal more concentration by industry and Government in training and updating skills and in instructing people more intensively than before.

It is conceivable to me that these two factors might possibly enable us to maintain or even to improve a little bit our productivity.

Mr. MADDEN. It certainly is conceivable. However, it would be surprising to us.

Senator PROXMIRE (presiding). I want to thank you very, very much, Dr. Madden.

You were on the staff of the Senate Banking Committee, I understand?

Dr. MADDEN. That is right.

Senator PROXMIRE. You certainly have a very able paper, much of which I agree with and I questioned you on the points on which we disagree, but it is a real addition to the hearings and we are mighty grateful to you for appearing.

Mr. MADDEN. Speaking for the chamber of commerce we appreciate very deeply this opportunity to participate in these hearings which we think are extremely important.

Senator PROXMIRE. The committee will stand in recess until 10 o'clock Tuesday morning here, at which time we will hear from the National Association of Manufacturers.

(Whereupon, at 2:55 p.m., the subcommittee recessed, to reconvene at 10 a.m., Tuesday, March 22, 1966.)

TAX CHANGES FOR SHORTRUN STABILIZATION

TUESDAY, MARCH 22, 1966

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 S–407, U.S. Capitol Building, Hon. Martha W. Griffiths (chairman of the joint subcommittee) presiding.

Present: Representative Griffiths; Senator Proxmire.

Also present: James W. Knowles, executive director; Nelson McClung, economist; and Hamilton D. Gewehr, administrative clerk.

Representative GRIFFITHS. The hearing will come to order. We are happy to have you here, Mr. Davidson.

I have already read your prepared statement and it is excellent.

TESTIMONY OF JOHN C. DAVIDSON, VICE PRESIDENT, GOVERNMENT FINANCE, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. DAVIDSON. Thank you very much, Madam Chairman.

My name is John C. Davidson. As a vice president of the National Association of Manufacturers, I have staff responsibility for policy formation and program development in the Government finance area. I greatly appreciate the opportunity to participate in these important hearings.

Your inquiry is concerned with the case for, and the mechanics and design of, quick tax changes. I believe you are wise in taking a look at this whole question in the broadest possible perspective.

Madam Chairman, I think I will just summarize my paper for the first eight pages and then read from then on, which gets to the crux of my positive proposal, if you have no objections.

Representative GRIFFITHS. You may do so.

Mr. DAVIDSON. All of us today are keenly and sympathically aware of the administration's current interest in finding a noncontroversial formula for a tax increase if it should be decided that one is necessary in the months ahead. While the quest has been presented as a search for neutrality, people will differ over what is neutral just as they will over what is fair in taxation. The approach which I present in this paper is that it is possible to take the controversy out of short-term tax changes only as they are an integral part of long-term tax policy. Unless part of a long-term program, it is my opinion that a temporary change in taxes should reflect the economic conditions of the period in which it is made. Moreover, I believe the idea of developing a single formula for either up or down temporary tax changes, independent of long-term policy, is an impractical one.

My paper is organized to answer a series of questions. I will refer to them briefly as I go through.

The first question is: Why was not a legislative framework for quick tax changes enacted long ago?

Well, the general answer here—and these are questions, Madam Chairman, which I have asked myself in preparing the paper—the first reason which struck me was that the public and the Congress, none of us, except perhaps some advance economic thinkers, were willing to accept the principle of repetitive red ink, which was an inhibiting factor in years gone by, an influence against doing something like enacting a legislative standby program of quick tax changes for economic reasons.

Representative GRIFFITHS. May I ask you this: Isn't it really true that the Federal budget, up until the last perhaps 40 years really was so small that tax changes would not have had too much effect?

Mr. DAVIDSON. That's correct.

Representative GRIFFITHS. It has only been recently that it made any real difference—that anybody can see the effect of either Federal spending or taxing—that it had any real effect upon the country at all?

Mr. DAVIDSON. That's correct. Up until the depression, it is my recollection that State and local taxes ran something like 10 percent of GNP, and Federal maybe 2 or 3 percent, or something like that. So the total take from GNP up until the depression was probably 12 or 13 percent.

Representative GRIFFITHS. Now it has only been within the last 12 years or 14 years that anybody has really come up to the Congress and said that something ought to be done about tax changes.

Mr. DAVIDSON. This idea, I believe, Madam Chairman, developed after a degree of pessimism developed in regard to the ability to change expenditures quickly.

Back in the depression and in the early planning after World War II, there was quite a general belief that we had to develop workshelves of expenditures and develop means for turning spending on or off rather rapidly. And it was from the feeling that this could not be done, that thinking originally turned to quick changes in the tax structure.

Representative GRIFFITHS. Yes. Thank you very much.

Mr. DAVIDSON. Now, the first point that I make under question 1 has to do with delegation of authority to the Chief Executive, and to summarize my views there, it just seems to me that the idea should be forgotten. It is not a question of whether Congress should or should not prove itself. I do not believe that Congress should or ever will delegate tax-changing authority to the President. It seems to me this is an idea which should be eliminated from discussions on the subject.

One of the things which has been interesting in the past is that, while there has been talk of temporary tax changes, the emphasis was always to counter inflation, and the formula and type of change to be used was always considered in relation to stimulation of the economy. It was not until the current fiscal crisis, if we might call it that, developed that the emphasis turned in the other direction, and at the time we wanted to use a standby authority was when we needed to increase taxes rather than decrease them.

I think this is of some significance in historical perspective.

I think it is interesting to note, and should be noted, that the very concept, the temporary concept itself, has no experience on the reduction side. Of course, always when you have a tax increase in an emergency, you like to say it is going to be terminated 1 or 2 or 3 years hence. But there is no practical experience in our background of making a temporary reduction in taxes. There are many situations where you may have reduced taxes and then wished you had not. But that is quite different from having been able to foresee those conditions in advance when you would want to terminate a tax reduction.

The question of neutrality is one which has puzzled me. I believe I have already commented on it briefly. But it just seems to me that you can have neutrality on a short-term basis only as it fits within an established pattern of tax policy, which means a long-term policy.

Now, to sum up on past thinking, my conclusion is that if there are to be short-term tax changes, unrelated to long-term tax policy, they should be tailored to current economic conditions, and that would mean even at the price of some delay in enactment. And this conclusion does rule out the development of a single formula for isolated up or down temporary changes. But it leaves open the question of providing a procedure for short-term changes which do fit into a long-term framework.

The next question I asked myself was, How does the experience of the 1964 cuts affect the case for quick tax cuts?

I think the most interesting point here is that in mid-1962, when those cuts were conceived, they were generally thought of in terms of temporary cuts, but long before we got to the point of enactment, it was agreed whatever was done should be done on a permanent basis, and especially there became a great degree of sophistication before the cuts were effected of the significance of the revenue gain from economic growth. I have followed these hearings quite carefully, and I was rather surprised, Madam Chairman, that there has been a lack of emphasis so far on the importance of the revenue gain in economic growth as a key element, a core—the basic thing you have to deal with when you talk about continuing a tax policy of any kind.

The next question I asked myself is, Why has a rather modest increase in military expenditures pushed official concern to the brink of a tax increase program?

I simply point out here that we started to increase domestic spending at the same time that we were putting into effect the 1964 tax cuts, and the 1965 excise tax cuts, and the military spending was unforeseen, the buildup, and it was just too much, and probably the mistake, in looking back, was pushing ahead with civilian spending until the tax cuts—until the time when the tax cuts had been fully absorbed within the economy.

Now, I am over to the major question: What kind of a realistic legislative program could be erected from our present state of knowledge, and I will read from my prepared statement now if I may.

Representative GRIFFITHS. All right.

Whichever term we use—fiscal surplus or revenue gain from economic growth—the phenomenon involved is basic to every fiscal decision of our time. Whether we are talking about spending increases or decreases, tax increases or decreases, or countering inflation or deflation, there is the built-in fact that a fully functioning economy will yield a revenue gain in the order of $7 or $8 billion annually. The availablity of this revenue gain is the central fact which makes practical a long-term tax with flexibility for short-term changes.

The core of our present knowledge on the revenue gain is that it is not an automatic blessing; not only must it be allocated to the most appropriate use, but typically this allocation must anticipate instead of follow its realization.

Nevertheless, fixed and irreversible allocation of the revenue gain in advance of its realization has a serious disadvantage. Although such allocation will assure that "fiscal drag" will not alone undermine economic growth, it will greatly handicap the Government in meeting fiscal emergencies. In effect, this is what has happened in domestic spending since 1964. If the Government had taken into account the possibility of emergencies such as the buildup of military effort in Vietnam, it presumably would not have kicked off the substantial increase in domestic spending following the 1964 tax cuts.

Put differently, as a means for meeting fiscal emergencies, the revenue gain is a highly valuable resource. However, it can't be stockpiled in the normal sense of the word because this would create "fiscal drag" and the gain would not be realized. Hence, it must be allocated in advance, but in such a way that the allocation is reversible if a fiscal emergency should develop.

The means would be legislation which would provide for short-term changes in tax rates within a schedule of long-term reductions vesting the prima facie claim of the taxpayer to the annual revenue gain. Mechanics of the legislation would involve subdividing the annual tax reduction into units, probably two or three for each year, and providing a procedure by which Congress could accelerate, decelerate, or even reverse the effectuation of the units of reduction. The reversal of reductions would be the means for effecting short-term increases in tax rates.

For example, if such legislation were based on a minimum estimate of revenue gain of $7 billion a year, and had been in effect for 2 years, the Congress would have available a total of $14 billion in past decreases which could be reimposed in units of $2–$3 billion. It could also reverse for the emergency an additional $7 billion allocated to the upcoming year. The legislation would contemplate review and extension before the final reductions are effected, so that there would be continuously available units of tax reduction to be speeded up, held back, or reimposed, as conditions might dictate.

It will be noted that this proposal would much more than accomplish the objectives of the original proposal for standby authority for temporary tax changes, while overcoming all of the objections to the basic elements of that proposal. All increases in tax would be temporary but subject to extension; all decreases would be permanent but subject to temporary reversal.

It is recognized that such a legislative program could not be used retroactively for effecting tax increases in the current emergency. However, if such legislation were in effect prospectively, it would set up a prior claim on the revenue gain, and postponement of the first scheduled unit or units of reduction would release substantial funds to support higher military spending or to generate a surplus to counter inflation.

Looking ahead, this proposal would provide maximum flexibility in adjusting Federal revenues to meet fiscal and economic emergencies. But even more than meeting emergencies, the aim of the proposal is to establish a continuing policy of earmarking revenue gain for tax reduction. In my view, such a policy should be continued at least until all rates of income tax are brought down to moderate levels.

It is clear, however, that the revenue gain from economic growth is a resource for us in fiscal emergencies only as it has not been encumbered in advance by spending programs. Unfortunately, a commitment to spend by the Federal Government stubbornly resists reversal in the political world. Moreover, all efforts since the 1930's to build reasonable workshelves of public spending projects, or to devise efficient procedures for rapid acceleration or deceleration of spending programs, have been unsuccessful. I believe it accurate to say that the idea of standby authority for quick tax changes grew out of the failure to produce workable concepts for quick changes in spending totals.

On the other hand, it should be noted that the earmarking of revenue gain for tax reduction would not rule out increases in domestic spending. It would mean simply that, whenever the President in January submitted an expenditure budget which would result in overuse of the revenue gain, he would ask the Congress to postpone a unit or units of the upcoming scheduled tax reduction as judgment indicated were necessary to prevent inflation while avoiding fiscal drag. This procedure would exert a discipline on increased spending by calculating its cost in terms of tax reduction dollars foregone. Such an equation is in itself a desirable feature of public budgetmaking procedures.

Finally, what should be the tax policy framework for such a legislative program?

The policy should be designed to continuously strengthen the conditions for high-level prosperity without inflation. This objective should be primary to the legislation, because it is wholly desirable quite apart from the problem of getting through temporary emergencies.

One of the great contributions which the administration has made to public understanding of economics has been in the area of the importance of profits and capital to progress and job creation. In making the case for the 1964 tax cuts, administration spokesmen emphasized this fundamental relation, and used it to clarify what is meant when economists refer to the phenomenon of "demand." I especially recall Walter Heller stressing that demand for capital goods is as important as the demand for consumer goods and services, and the need was to lift both up to achieve a fully functioning and growing economy.

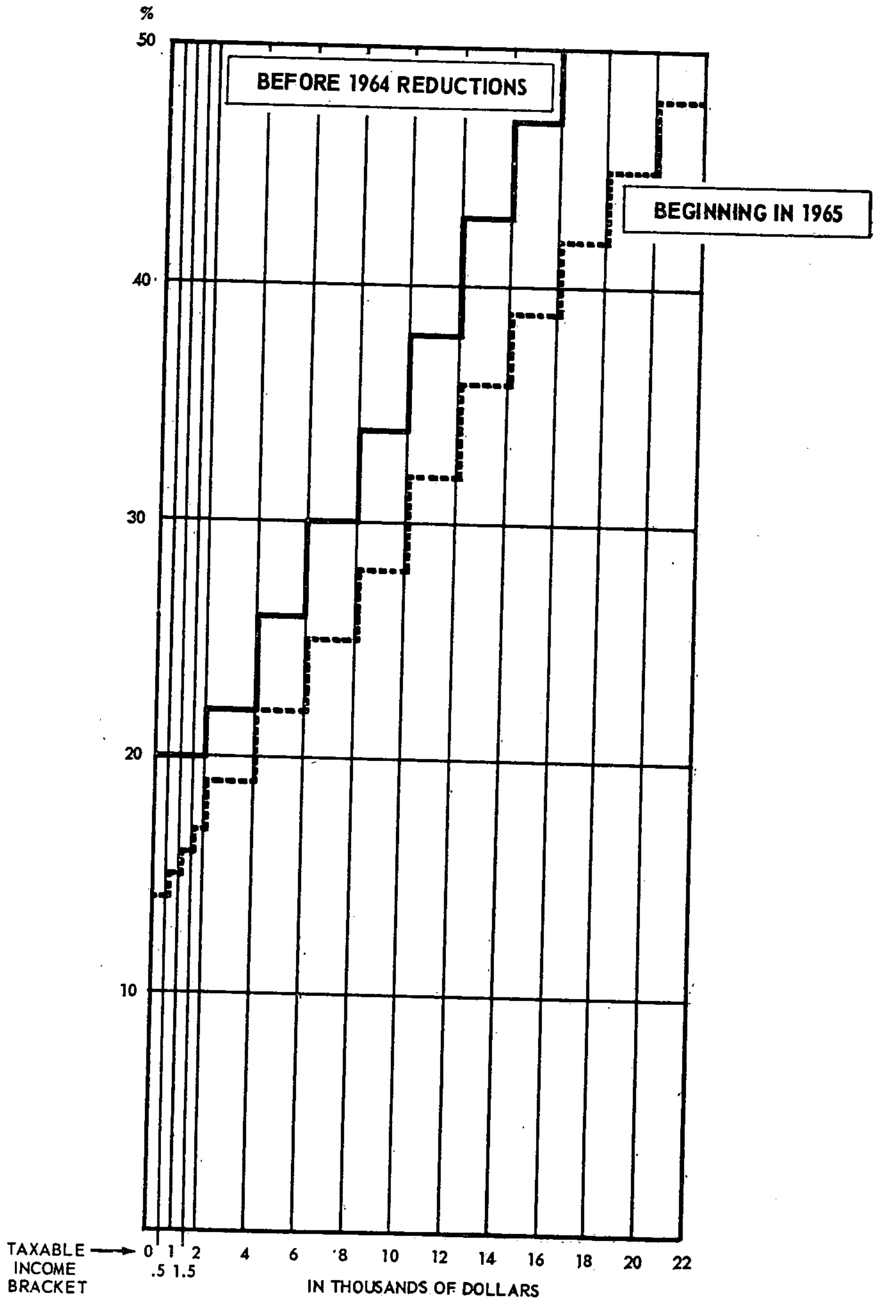
Unfortunately, however, the tax cuts were structured more to the use of consumer demand to create investment demand than they were to the direct release of tax restraints on capital formation. If there had been greater reduction of tax rates through the middle and higher income brackets, and on corporate income, capital expansion would not now be so dependent on new bank credit.

As shown by charts I and IA, there was substantial modernization in tax rates from the bottom to the top of the scale, but the least moderation came where the rates climbed most steeply through the middle brackets.

(The charts referred to follow:)

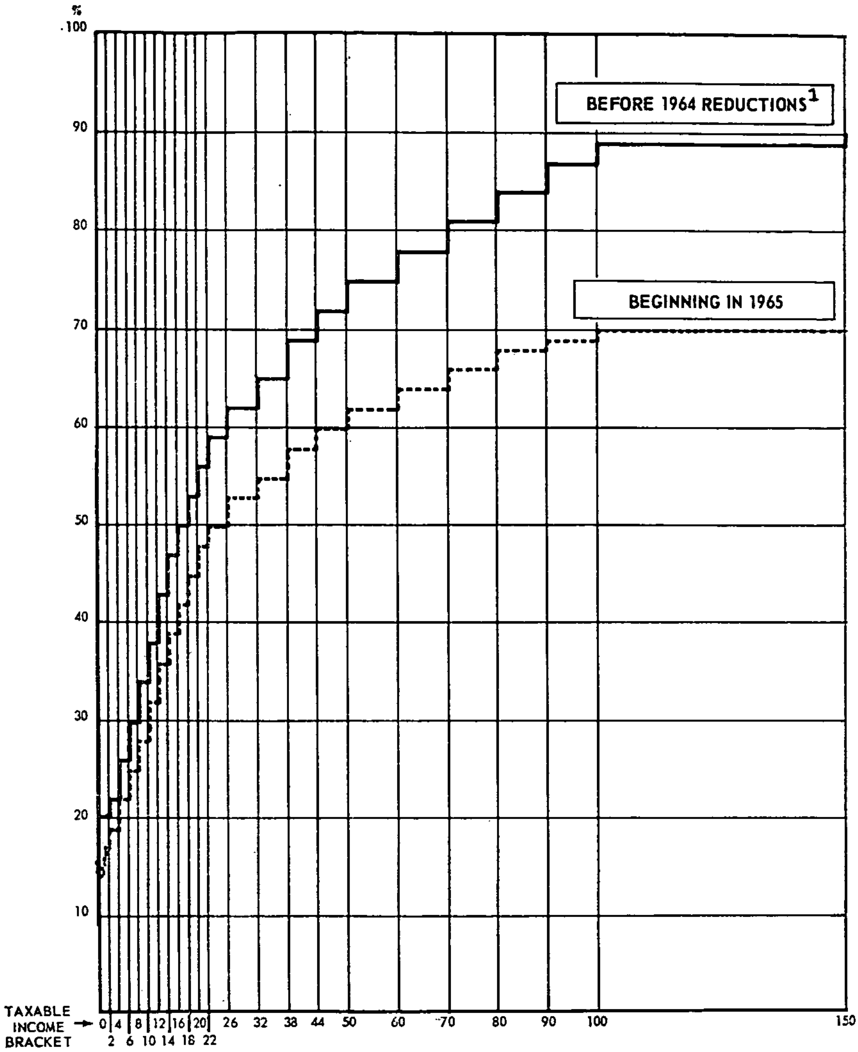
CHART I

DETAIL OF BRACKETS 0 TO $22,000



This detail is doubled in percentage scale and quadrupled in tax bracket scale.

CHART IA—PERSONAL TAX RATES



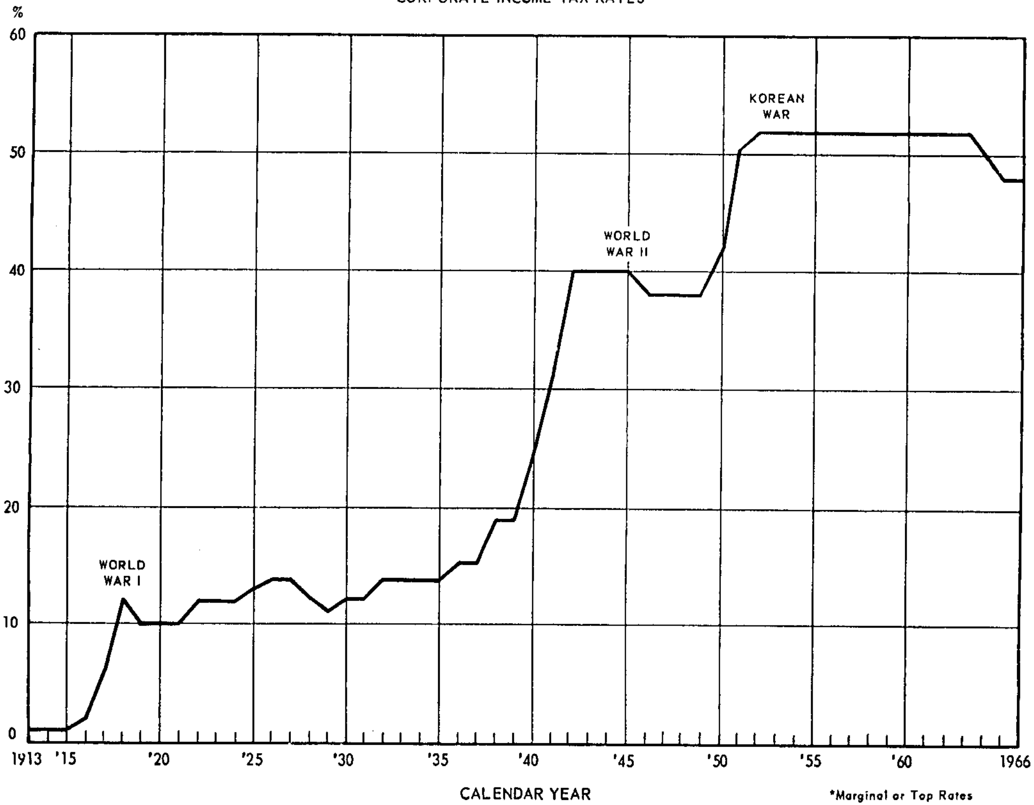
[1] Beginning $150,000, rate is 90 percent; beginning $200,000, rate is 91 percent.

As shown by chart II, the modest reduction in the top corporate rate reaffirms a disturbing fact of income tax history—the tendency of the wartime level of regular corporate tax rates to be continued in peacetime, and thus to become the base for further upward movement of the rates in the next emergency.

(The chart No. II follows:)

CHART II

CORPORATE INCOME TAX RATES*



*Marginal or Top Rates

Under contemporary conditions it is apparent that increase in the corporate tax burden would not diminish the pressures which consumer demand are placing on productive capacity, but would simply reduce the noninflationary funds available to meet those pressures. However, an increase in tax burdens which diminished consumer demand would take some of the pressures off bank credit.

I believe it would be a mistake, moreover, to assume that the scarcity of saved capital is a temporary condition. It would appear to be normal for high-level prosperity, at least as long as tax rates place a disproportionate burden on voluntary savings by individuals and business. If we are serious about opening up a new era of economic growth, with minimal unemployment and maximum advancement in human well-being, it is my opinion that a problem we must face is a tendency of our economy to run short of capital whenever things get humming. We see an inexhaustible need for capital in the rest of the world, and we should recognize that the same condition exists at home.

Thus, in setting the tax policy framework for a legislative program of long-term tax cuts, subjective to short-term changes down and up, I believe the great emphasis should be on moderating the steep climb of personal rate graduation, and reducing the inordinately high level of corporate rates.

In conclusion, a summary of my statement is as follows:

First, standby legislation which would provide a single formula for quick tax changes up and down, as has been discussed for a number of years, is not practical.

Second, standing alone, a temporary change in taxes should reflect the economic conditions of the period in which it is made.

Third, the revenue gain from economic growth, now in the order of $7 to $8 billion annually, is basic to every fiscal decision of our time, but its encumbrance in advance for spending makes it unavailable for use in fiscal emergencies.

Fourth, a legislative program which would provide for short-term changes in tax rates within a schedule of long-term reductions is highly desirable, and is wholly feasible if the revenue gain from economic growth is allocated for that purpose.

Fifth, such a program would enable Congress to speed up, hold back, or reimpose units of tax reduction, as judgment determined in a fiscal or economic emergency, and without controversy over the neutrality or fairness of the changes.

Sixth, the tax policy for a program of long-term tax reductions should place heavy emphasis on easing the capital shortage which is characteristic of high-level prosperity in our time.

Thank you.

(The portion of Mr. Davidson's written statement not read during the hearing follows:)

STATEMENT OF JOHN C. DAVIDSON

* * * * * * *

As I will develop in this statement, I believe the problem of quick tax changes requires a fundamental break with the approach which has been contemplated in the past. I have a new approach to offer. It can be best explained after a review of past thinking on the problem. It derives from an examination of fiscal developments since the 1964 tax cuts and from observation of the now emerging economic problems of a high-level employment economy. This is the level of economic activity we want to maintain and to do so we must face the problems it brings.

* * * * * * *

The questions which I have asked myself follow:

1. Why was not a legislative framework for quick tax changes enacted long ago?
2. How does the experience of the 1964 tax cuts affect the case for quick cuts?
3. Why has a rather modest increase in military expenditures pushed official concern to the brink of a tax increase program?
4. What kind of a realistic legislative program could be erected from our present state of knowledge?
5. What should be the tax policy framework for such a program?

1. WHY WAS NOT A LEGISLATIVE FRAMEWORK FOR QUICK TAX CHANGES ENACTED LONG AGO?

When the idea of quick tax changes first came into prominence, fiscal policy theory had long centered on counteraction against economic fluctuations, typically against deflation, but also against inflation. The thought was that sharp increases or decreases in purchasing power, as the case might be, would swing the economy back toward balanced prosperity.

While up to that time the Congress had repeatedly shown willingness to reduce taxes after a military emergency before the budget was balanced, red ink in principle was still quite generally considered to be something like original sin. Thus, the political environment would not have permitted the enactment of legislation which anticipated recurring need to cut taxes in order to substantially widen a deficit as an economic prop. Under the handicap of such a climate, what the important elements of quick tax changes were did not then make too much difference. For the purposes of these hearings, however, they are of critical concern.

The list of elements considered important might vary, but I suggest here four which need to be kept in mind:

(*a*) *Delegation of authority to the Chief Executive.*—The key element of the original thinking was that the power to change tax rates within prescribed limits should be delegated by Congress to the Chief Executive.

Whatever the safeguards or limitations, such a delegation of power runs counter to our political mores. It is one thing for the economist to visualize the benefits to the economy as a whole from abrupt changes in aggregate taxpayments, but the problem looks quite different when the political scientist views it. Taxation is an involuntary extraction of income or wealth, and the power to increase or diminish taxes is the ultimate power of Government over the individual citizen. The determination of when a tax does or does not apply is inseparable from the power to make the levy in the first place.

I have always believed that congressional opposition to delegation reflects deep concern with fundamental principles on which our society rests, and is not a shortsighted desire to safeguard a prerogative.

Recently, the view has developed that Congress should be given the opportunity to prove that it can act quickly. Of course, no one can say for certain what the Congress will or will not do, but it does seem to me that the idea of delegating tax-changing authority should be dismissed once and for all.

(*b*) *Direction of changes.*—The proposal for quick changes has always been stated as being concerned with upward as well as downward changes in tax rates, but practical concern with upward changes has come about only in the contemporary period.

One idea which was widely circulated a number of years ago was that the Executive's power should be limited to five percentage points in the rate of tax in the first bracket of taxable income only. This idea seemed directed only at tax decreases. It did not consider the point that an increase of this magnitude could not be made without overrunning the next higher bracket. I believe it is accurate to say that from the beginning those who felt most strongly about the proposal were preoccupied with the use of fiscal policy to stimulate economic activity. Even as late as January 1964, in his Economic Report, the President used the words, " * * * rapid action on temporary tax cuts if recession threatens."

(*c*) *The temporary concept.*—The placing of a time limit on quick tax changes has been inherent in the proposal.

Quite apart from this proposal, the placing of a time limit on tax increases is an accepted idea supported by experience.

However, the concept of temporary reductions has been essentially a theoretical one, lacking experience orientation. There is no lack of experience on the necessity for reversing reductions, but the conditions requiring reversal could not be foreseen. I may have overlooked pertinent literature, but I do not recall any proponent of quick tax changes having drawn a model into which a temporary tax reduction would fit.

(*d*) *Neutrality of temporary tax changes.*—In advancing the proposal, stress has always been placed on the notion that the short-term tax changes should be neutral, and unrelated to and divorced from permanent or long-term tax policy.

Unfortunately, there seems to be no objective way of defining "neutrality." The concept of what it means seems to go in one direction when tax cutting is the major concern, and in the other when tax raising is the order of business. This is because people's notions of neutrality tend to correlate with their ideas of fairness. Contrary to past thinking, it appears to me that this dilemma can be effectively resolved only by getting long-term tax policy into the equation.

To sum up on prior thinking, I believe it fair to say that it did not provide a practical framework for legislation.

My conclusion is that, if there are to be short-term tax changes unrelated to long-term policy, they should be tailored to current economic conditions—even at the price of some delay in enactment. This conclusion rules out the development of a single formula for isolated up or down temporary tax changes. But it leaves open the question of providing a procedure for short-term changes which does fit into a long-term framework.

2. HOW DOES THE EXPERIENCE OF THE 1964 TAX CUTS AFFECT THE CASE FOR QUICK CUTS?

Within the general atmosphere of satisfaction with the 1964 tax cuts, it comes somewhat as a shock to recall that a critical question about those cuts, when conceived in mid-1962, was whether they should be temporary. At the point of initial conception of the cuts, fear was developing that a leveling out of economic activity would turn into deflation. By the time of enactment, however, economic conditions were much improved.

From the standpoint of economic policy, the three most important aspects of the 1964 cuts as they ultimately turned out were:

(*a*) Their justification rested nearly entirely on taking the "lag" out of economic growth and employment, instead of counteracting deflation as such.

(*b*) They were designed to effect permanent if moderate relief from excessive tax rates, as well as to substantially increase aggregate demand in the economy.

(*c*) They were tailored to anticipating and using in advance the revenue gain from adequate economic growth, instead of injecting a hot and temporary shot of new spending power into the economy.

As a whole, it seems a fair statement that the 1964 legislation as it turned out was more of a repudiation than an acceptance of the original thinking on quick tax changes. It treated the chronic problem of fiscal drag rather than any set of problems peculiar to 1963 or 1964. Its success, I believe, was due to this conception of its purpose. However, the legislation did reflect a modification in political environment, to the point where a temporary increase in red ink in order to strengthen the economy is no longer in itself unacceptable.

3. WHY HAS A RATHER MODEST INCREASE IN MILITARY EXPENDITURES PUSHED OFFICIAL CONCERN TO THE BRINK OF A TAX INCREASE PROGRAM?

The answer, in part at least, is because the military increases have come on top of increases in domestic spending since 1964. The current value of the income tax cuts of 1964, plus the realized excise tax cuts of 1965, is in the order of $20 billion annually—or the equivalent of the revenue gain for about 3 years. Nevertheless, from fiscal year 1964, the President's estimates for fiscal year 1967 show a growth of nearly $6 billion in domestic spending, and only a little more than $7 billion in military spending. If domestic spending had been held level until the economy had absorbed the full effects of the tax cuts, other things unchanged the President would have been able to show a surplus of $4 billion in his estimates for fiscal year 1967. The uptrend in domestic spending points to what seems a somewhat irrational trend in national economic policy beginning before the ink was dry on the 1964 cuts.

The broad consensus in support of the 1964 cuts was brought about by important concessions from opposing philosophies. On the one hand, there was considerable retreat from preconceived notions that budget balance should precede or at least be simultaneous with tax reduction. On the other, there was at least equal retreat from the notion that increase in spending is better than reduction in taxes as an economic stimulant.

The retreat on budget balance still holds. There are not many left among us who believe that fiscal policy must be anchored to annual budget balance.

On the other side, however, the retreat proved only temporary. Some economists who were influential in achieving the 1964 cuts were among the first to say that this action did not necessarily provide a desirable pattern for the future. While correctly emphasizing that unused revenue gain must never be allowed to become a drag on the economy, the weight of their views seemed to be that spending the gain may have intrinsic value greater than tax reduction. It is this view which seems to have provided economic cover, so to speak, for the substantial, and by all standards premature, increase in domestic spending since 1964.

At any event, if it becomes necessary to increase taxes in the period ahead, the blame should not be placed on the Vietnam situation alone.

* * * * * * *

(Remainder of prepared statement appears in preceding testimony of Mr. Davidson.)

Representative GRIFFITHS. Thank you, very much.

I think you have made a very interesting suggestion and a very constructive suggestion.

May I ask you this? If we had it all to do over, which of the tax changes would you have put into effect—would you have reduced excise taxes, would you have reduced only income taxes, personal income taxes, corporate income taxes, would you have given the investment tax credit?

Mr. DAVIDSON. If we had it to do over again—I don't think I would change any of the tax decisions that have been made in the last few years. I might have changed the composition of the income tax cuts, Madam Chairman. I think our basic problem today is that we have cut taxes and started an increase in spending at the same time.

Representative GRIFFITHS. In reality, we have cut taxes and kept cutting taxes without waiting to see what the effect would be. That was a real error.

Mr. DAVIDSON. You know, it seems like a long time ago, but back in May, June, and July of last year, the basic concern in Washington was whether or not we would be—the boom would kind of level off and turn down the rest of the year. Of course, what happened is the Vietnam situation has been superimposed. The Vietnam situation in and of itself is not a large chunk of money, but superimposed on a fully operating economy, it has been a little too much to take.

Representative GRIFFITHS. Vietnam is not as large a chunk of the economy right now as the tax cuts, is it?

Mr. DAVIDSON. No. Tax cuts have amounted to about $20 billion. Vietnam is about $10 billion, so far. Of course, the pickup in revenue for next year, in the legislation just passed, puts back $5 or $6 billion, but mostly on a transitory basis.

Representative GRIFFITHS. How long a period of time would you encompass in these tax changes that you suggest?

Mr. DAVIDSON. Well, I don't think the length of time is as important as the concept—but 4, 5, 6 years. I would say that 6 would be probably the outside, and 4 would probably be—you would nearly have to do it on a 4-year basis to build up any flexibility.

Now, after legislation was once enacted, and if it ran for 2 or 3 years, you could extend it—you would not necessarily have to extend it for as long a period beyond as you would to get it going. The important thing to do in this kind of program is build up a stockpile of tax reductions which would be available for use in an emergency.

Representative GRIFFITHS. Would you assume if you knew now that over the next 4 years taxes were going to do down, that it would increase the need for capital?

Mr. DAVIDSON. Well, it would be an optimistic point, but I don't think it would have any great significance. I don't think that forward business planning is tied that closely to public policy. I think forward business planning today is tied very definitely to the commitment of the Government to maintaining the conditions for prosperity in America, and within that total framework, I am not sure that planning would be affected too much by a precise expectation of reduction in taxes.

We were talking generally.

If you meant in your question, if this were enacted and on the books——

Representative GRIFFITHS. Yes—so that everybody knows.

Mr. DAVIDSON. I think it would be, yes.

Representative GRIFFITHS. For years in advance these taxes were going to go down—it would, in effect, create an increase in need for capital.

Mr. DAVIDSON. Yes. It would mean improvement in the environment for investment, without question. But it also would probably mean that the Federal Reserve Board would have to take into account this environment in controlling the supply of money and credit in the economy. Of course, you know——

Representative GRIFFITHS. And increase interest rates.

Mr. DAVIDSON. Well, perhaps. Whatever is the best tool.

I am not a great expert in that area. I happen to think—I happen to incline a little bit more to the use of controlling actual supply of funds rather than the rates. But I could be wrong. I am not that good an expert in that field.

Representative GRIFFITHS. Well, the same thing that caused business investment with increased prosperity would cause consumers to invest also, it seems to me.

Mr. DAVIDSON. That's right.

Representative GRIFFITHS. And very possibly would not actually cause them to save money?

Mr. DAVIDSON. That's right. You are pushing at a very interesting point. What would be the psychology of a public policy in which we really did expect more or less continuous prosperity under increasingly favorable tax environment? It is quite an attractive picture when you think about it.

Representative GRIFFITHS. Yes, it is, very.

I want to ask you this. Do you assume in this discussion a balanced budget annually?

Mr. DAVIDSON. Oh, no, not at all.

Representative GRIFFITHS. How much——

Mr. DAVIDSON. I assume that the revenue gain would essentially be anticipated, you see, and reflected, so that other things being equal, the budget would be balanced. In other words, you would simply be returning in taxes each year the amount of the revenue gain, and if you had level expenditures you would end up with budget balance. But the important thing is to get ahead of it rather than after it. You don't wait until the surplus gets there and then reduce taxes.

I suppose that over a period of time—the decision as to whether or not you were going to seek a balanced budget in a particular year is a decision you have to make that year, and not make in the long term. The whole concept of your program is that it would use the revenue gain allocated for the purpose and from this standpoint it would match, or be offset, by the spending level. So you would have a balanced concept. But it could well be, if in January the administration, looking at the perspective picture, might say—well, things are not quite as zippy as we would like, so we will put in another unit of tax reduction this year, and that would unbalance any preconceived relation—is the point I am making.

Representative GRIFFITHS. Would you subscribe to the theory that it would be a good idea if we had a quarterly review of the economy by the economic advisers in place of an annual review?

Mr. DAVIDSON. Well, both; I think I would say, yes.

Representative GRIFFITHS. A quarterly review?

Mr. DAVIDSON. Yes, I think a quarterly review would be a very good thing, very good.

Representative GRIFFITHS. So that if your theory of this tax reduction or increase were in effect, you could also easily look at the opportunity to determine whether or not you put them into effect this quarter or stop them.

Mr. DAVIDSON. I think so.

The plan still intrigues me because I cannot quite visualize the idea of making a tax cut without getting into an argument over who gets the benefits. And yet I think it is eliminated by this procedure. So if economics indicated the necessity, and public policy were geared to using the budget this way, you would do it.

Representative GRIFFITHS. It would not eliminate in the first instance. The first time you set up the bill——

Mr. DAVIDSON. It would take time to get into this position.

Representative GRIFFITHS. That's right—because you would go through all the arguments originally as to who is going to get the tax cut.

Mr. DAVIDSON. That's right. But it would be settled.

Representative GRIFFITHS. How do you think you make it neutral, in the first instance?

Mr. DAVIDSON. In the first instance?

Representative GRIFFITHS. Yes.

Mr. DAVIDSON. Well, my proposal for the long-term program is that the long-term program would tend to undo what I consider the built-in excesses of the present system. From a personal standpoint, both as a matter of equity and economics, the system penalizes effort, it penalizes success, and it makes it more difficult for enterprising people to accumulate capital out of earned income. The younger members of our economy have a hard time acquiring equity capital.

So I would tend to correct that over a number of years.

By the same token, I would correct what I consider to be a totally excessive level of corporate taxes.

Representative GRIFFITHS. Do you happen to know offhand what the loss would have been to the Treasury if the upper bracket had been reduced 20 percent?

Mr. DAVIDSON. Last time?

Representative GRIFFITHS. Yes; 20 percent additionally?

Mr. DAVIDSON. About $1.3 billion, I think. I worked around with these figures a good bit at that time and it seemed to me we are dealing with a little more than a billion dollars—very fractional out of $11 billion in tax cuts in the then contemporary dollars. It would be very easy to do if a political decision is made to do it.

Representative GRIFFITHS. But actually it does not free really too much money, though, does it?

Mr. DAVIDSON. No; it would leave money in our most dynamic hands. This is the point. Today money tends to accumulate in the hands of those who have been successful, and our taxes tend to deprive venture capital from those who are striving to become successful. I call it lead money. I think the tax system of graduation really represses what you really would consider the lead money of growth, the most enterprising money.

Representative GRIFFITHS. May I ask you this: If you assume—and I do assume—that if you put into effect a tax cut which meant that for 4 or 6 years in the future taxes were going to go down—although it could be stopped and it could be reversed—that chances were that they were going to go down, I think that you would have increased demands for capital; I think you would have a tremendous spending boom on every level.

Now, I would like to ask you this: Do you think you would also have increased demands for governmental services?

Mr. DAVIDSON. Well, demands for governmental services seem to come from one or two reasons: First, we can afford it because we are affluent; and second, we have to do it because we are depressed. So you can hardly win on this argument of Government expenditures in our time.

I don't think so myself. Strange as it may seem, we have a number of programs which have been launched over the last few years—but mostly, despite the general atmosphere of being able to afford it, much of what we know as the Great Society program was actually conceived when we were in a chronic economic lag. We did have a problem with depressed areas and depressed conditions. This is where most of these problems go back to.

If one were developing programs today from the top of prosperity rather than from some period of economic lag, I would suspect the mix would be different, maybe the arguments would be different.

Of course, you do get to the point where you can afford more. There is no question about it. And I am not trying at all to pretend here that there are not a lot of things the Government is not doing today that it wouldn't want to do in the future and probably should do. But also it seems to me we have to grow up in this country and get to a point where the Government can stop doing things that don't make sense and cut down on doing some things. This is something we have not made any dent on in the political world. It seems once we get a spending commitment on the books, it is there forever. And this is an area where we need to study and find out—how do you change and reverse spending on a long-term basis?

How do you get agreement that a program is tired and worn out and has served its place, and we can better use the money for other things?

Representative GRIFFITHS. You might cut down on some of the training programs—if you cut unemployment to 2 percent, but in addition, you would necessitate training programs at a higher level. That is, you are not going to stop now training doctors and nurses and scientists—the demand would be greater, not less.

Mr. DAVIDSON. That's right.

Representative GRIFFITHS. And that is very expensive training.

Mr. DAVIDSON. That's right.

Well, there is no doubt that high-level prosperity will put pressure on all of our resources. Our capital resources, manpower resources, productive resources, on everything. This is the price of high-level prosperity. There isn't any other way. This is what it is basically.

Representative GRIFFITHS. It would be nice to worry about that in place of unemployment.

Mr. DAVIDSON. Yes. Anyone who is trainable and wants to work can always find a place to work—it is something nice to think about. And we look even today at these training programs. Remember that we have had a great argument over the last decade as to whether or not our basic problem was structural unemployment or unemployment because we were not growing fast enough. I happen to be part of the growth school. I never thought our basic problem was structural.

Now, you look at current Government programs for training—those which are fundamentally based—if they are, and I am not this much of an expert—there is the notion that the problem was structural to begin with, and it might not have too much reason for existence in the kind of situation we are moving into because the market itself creates the employment opportunities and provides the training.

To the extent that training programs are designed to deal with people who would not otherwise find their way into the labor market, it is quite a different matter, of course.

Representative GRIFFITHS. Senator Proxmire?

Senator PROXMIRE. Mr. Davidson, I have had a chance to study this statement. I think it is very interesting. It's good to get a positive, constructive proposal.

Of course, you stick your neck out when you do that but that's the only way we make progress.

Mr. DAVIDSON. I should have said—collaborating with me in the preparation of this statement has been George Hagerdorn who has appeared many times before this committee, and also Milton Leontiades, our director of tax analysis.

Senator PROXMIRE. I want to be sure I understand your position.

Do you or do you not advocate a tax increase now?

Mr. DAVIDSON. I do not.

Senator PROXMIRE. You do not. What you advocate instead, as I understand it, is that we prepare a kind of a system which will enable us, under future circumstances of this kind, to postpone a tax reduction, and then, No. 2, you advocate a reduction in spending at the present time?

Mr. DAVIDSON. I did not put the emphasis on reduction of spending. I said our problem has been created by perhaps a too early increase in spending when we were cutting taxes. Perhaps I should not have said "Yes" a moment ago.

My paper itself is noncommittal on the necessity for a tax increase at the present time. It simply emphasizes that if there is a tax increase now, it should be tailored to the conditions in which we are in today, and we should not try to find some neutral formula, because it is probably impossible to find.

I answered your question a moment ago as to whether or not I do or do not favor a tax increase right now—the answer is "No."

Senator PROXMIRE. You speak for the NAM opposing a tax cut at the present time?

Mr. DAVIDSON. No; no. This is not a question which I have at all taken into policy channels and there is no association position at this time.

Senator PROXMIRE. You are speaking as an individual?

Mr. DAVIDSON. Speaking as an individual.

Senator PROXMIRE. As an economist, you oppose a tax rise now?

Mr. DAVIDSON. I think I should say this: If the administration should recommend a tax increase at this time, certainly I would be the first to say that it should be sympathetically considered, and if they, from their position and knowledge of what is happening economically in the economy, and what the spending plans are, in Vietnam and so forth, should reach the conclusion that a tax increase was necessary, my inclination would be to go along with that conclusion.

I have a feeling—I cannot commit the association—but I have a feeling that the business community would, too. That would be my feeling.

But the administration has not proposed that.

Senator PROXMIRE. One of the reasons we are holding these hearings, as I understand, is to get the advice, for the administration, as well as for Congress, from the top experts in the country, on whether or not they feel we should have a particular kind of a tax increase, and also it is very helpful if, in your judgment on the basis of present economic conditions, the shortage of skilled labor, the pressing against plant capacity, the rise in the wholesale price index, all these things would lead you at the present time to advocate a tax increase, and you say no, you prefer to wait to see what the President requests, and then you would sympathetically consider that. Is that correct?

Mr. DAVIDSON. Well, your summary is correct. It probably does not cover all of my thinking. I don't know—perhaps it would have been wise to have increased taxes some time before now—maybe the first of January. There is no doubt about the big needle that we got in the economy in the last part of last year and the early part of this year, and before the Fed decided to tighten the screws, so to speak.

Whatever has happened in the past is pretty much already in the economy in my judgment, and to increase taxes right now, I don't think it would prevent any inflation that we are going to have anyway. I am not sure that it is necessary to, in the future, unless there are going to be significant, substantial, additional increases in spending.

If the administration should come in with any substantial step-up of military spending, in my opinion, there should be a tax increase.

Senator PROXMIRE. Do you have any advice about what we should do for inflationary forces on the economy—the spending area, taxing area, credit controls, other controls, monetary policies, any other kind of policy, you think would be appropriate now?

Mr. DAVIDSON. Well, first, Senator, I do think that the domestic spending should be reduced to the extent possible. Now, I have not made a great play on this because I recognize the problems of cutting spending. But if the Congress and the administration could combine to reduce the level of spending for next year by several billion dollars, I think this would be a tremendously healthy thing.

Senator PROXMIRE. You mean the coming budget, beginning July 1?

Mr. DAVIDSON. Fiscal year 1967—I think this would be one of the healthiest things that could be done.

Senator PROXMIRE. Can you suggest where we might do that?

Mr. DAVIDSON. Well, this is the problem of course. Most spending commitments are based on doing things which at the time in history people think are necessary to do and people develop expectations, both those who work on programs and those who are the ultimate beneficiaries of the programs.

It is very difficult to reverse because 180 million people pay the tax burden, but maybe 500,000 get the benefit of this little chunk.

Senator PROXMIRE. You are the spokesman for the National Association of Manufacturers. I would think that the NAM of all organizations—it's a great organization, a conservative organization—would have a specific proposal on where we can cut spending. If the NAM, with its great reputation for conservatism, hard-earned reputation, cannot point to any specific area where we can cut spending, I think it is surprising. And, of course, you cannot expect the Congress and President to act without some kind of expert advice from the outside.

Mr. DAVIDSON. I am not trying to evade your questions, Senator. We do have a government expenditures committee and it happens to be one of the responsibilities which reports to me, staffwise. It is run by another person of the staff under me. I have been preoccupied recently. I really did not, until this morning, begin to realize that I might be pressed on this kind of a thing.

We came up with a recommendation for cutting the 1967 budget from \$2 to \$3 billion. I would have to go back and check it precisely; I forgot to consult with my experts before I left New York.

We think it should be done. But you are asking me as a professional at this stage in history, as to whether or not I think this is realistic to expect it to be done. I just don't want to have any pretenses with you.

Senator PROXMIRE. You will have a few days to correct your remarks. If you could provide for the committee where this \$2 to \$3 billion spending reduction should be, it would be helpful.

(Material subsequently submitted by Mr. Davidson in response to Senator Proxmire's suggestion appears in this volume following Mr. Davidson's testimony. See p. 201.)

Mr. DAVIDSON. I do have a few items which I might mention. I put these down between 9 and 9:30 this morning, because I suddenly—reading the dialog with Mr. Madden last Friday—realized that you probably would really push me on this.

First, one of the things which seems rather irrational in the budget for next year is the proposal to increase civilian employment 50,000.

Senator PROXMIRE. You are the first witness who put his finger on that. I think that is very helpful.

There is no question if we are going to increase the number of Federal employees to the highest level since World War II, which is being done, and it is an increase of 61,000, this represents increasing pressure on the economy, it does tend to aggravate the shortage of skilled labor. I think it is interesting that you raise that point. It is a good point.

Mr. DAVIDSON. Well, secondly, a program to me which was not widely accepted or applauded even when it was conceived in different conditions was the depressed areas program, which is now the area redevelopment program. This is not a question of slums or this sort of a problem. This is a question of the Federal Government trying to solve community problems and it all goes back to a concept of depressed areas. It seems to me that whole concept should be thrown out of the window.

Senator PROXMIRE. We certainly have depressed areas in the country today.

Mr. DAVIDSON. There is an increase of nearly $100 million in what is now that program, 1967 over 1966.

Senator PROXMIRE. Three things about that program: No. 1, it was very inadequately funded before; No. 2, it is primarily a loan program; No. 3, we could not come close to doing any kind of a job in these depressed areas before. It is true that the number of depressed areas has diminished, the number of counties qualifying has diminished. We should be able to begin to do a job.

This program is primarily loans to business, about 90 percent of it, at a low interest rate, to go into a depressed area, to provide jobs for people out of work, and also to provide incentives for them to train unskilled labor and begin to move the community ahead.

At any rate, you think these loans should be reduced?

Mr. DAVIDSON. Oh, yes; without question.

Senator PROXMIRE. What other area?

Mr. DAVIDSON. Well, here is another item pointed out to me this morning. Apparently there is an item in the budget for next year for $40 million to create an air museum. This might be a very desirable thing, but do we have to do it now? Do we have to do it in 1967?

Senator PROXMIRE. I think there are lots of those frills.

Mr. DAVIDSON. Another thing that does impress me—there seems to be a general expansion in the whole urban renewal package for next year. Again, these are things that should not have too much priority in this kind of a period. I mean if the Federal Government is going to stay heavily committed here—it could slow down its commitment until we have more resources that could be applied in this area.

Senator PROXMIRE. Would you include road construction?

Mr. DAVIDSON. No; I would not.

Senator PROXMIRE. Why not?

Mr. DAVIDSON. It is a long-term program of providing something that is very indispensable to our society which is good roads and good opportunities, and I don't think to cut down on this kind of a program——

Senator PROXMIRE. Why not postpone part of it, reduce it? It has been proceeding at such an enormously rapid rate. It has nothing to do with education. It puts pressure on prices. It is a huge program.

Mr. DAVIDSON. I might have overstated it. Maybe it could be slowed down. It is a program we have not dealt with analytically. I realized this question would probably come up. Perhaps my orientation here is one of believing the road program is a good program, you see. I am more likely to be in favor of cutting down on things that I am not so much in favor of to begin with.

Representative GRIFFITHS. I am going to come to your rescue.

I think a really good argument could be made for the fact that cutting down the road program is really inflationary. Anything that lengthens the haul of the supplier to the plant is inflationary.

Mr. DAVIDSON. There is no doubt that a good road program, going back to the program of 1958—it has tremendously increased the efficiency of transportation.

Senator PROXMIRE. I would agree with that wholeheartedly. I would agree with the observation of the distinguished chairman. But what we are talking about is timing. These roads are not going to be finished in many cases for years. If you are going to take the pressure off, the whole thrust of the administration's tax program, for example, has been to take the pressure off prices now with a one-shot temporary package. And assuming that there is going to be a need for more jobs and more activity in the future. So if you are going to have a program you can postpone, it seems to me that construction, including roadbuilding, might be one that you might want to look at.

Mr. DAVIDSON. I read in the Washington Post this morning the story of the Beltway—Route 495—around Washington. What is amazing is that this road which was not here a few years ago today is an indispensable part of getting around.

Senator PROXMIRE. I am certainly for it. But maybe this is the kind of convenient but nonessential expenditure where the President could move in quickly.

Mr. DAVIDSON. Well, perhaps I might say this. Again, this is the sort of thing—if the President decided to do it, I am sure that NAM is the last organization in the world to tell the President that he is wrong. It is not the type of thing that we would say you should do, Mr. President.

Senator PROXMIRE. NAM is what? Did I hear you right?

Mr. DAVIDSON. The last organization that would argue with the President—if the President made the decision that the road program should be slowed down and stretched out.

Senator PROXMIRE. I thought you were saying that NAM is the last organization in the world that would tell the President he is wrong.

Mr. DAVIDSON. No—wrong on this particular point only. I don't—I think we have an undeserved reputation for telling the President he's wrong. He has been right, Presidents in recent history, many, many times, more often than not have been right.

Senator PROXMIRE. Am I unfair about your overall proposal, when it seems to me that it would give a bias toward the tax cuts and against Government spending, or against increasing Government services? The way your proposal would operate, as I understand it, is that you would have, as you put it, a permanent program of regular tax reduction, and no program of meeting the need for—expanding need for Government services. So you would constantly have a pressure on keeping spending down, and an automatic tax reduction unless the President and the Congress intervened and decided to take what would be a politically courageous and unpopular decision in most cases of interrupting that tax cut in order to provide the kind of services that, in their judgment, we might need for education and other purposes.

Isn't that the danger—that you are going to put the Government in a position of denying the services to a growing society and a complicating society that might be necessary?

Mr. DAVIDSON. It would make it much tougher for the Government to increase spending. Under the present circumstances where the Government does not have to account to the taxpayer for $7 or $8 billion a year, it is very easy for the Government to use that much money to win favor with those who would be the beneficiaries of the spending programs, and those who would work on the programs. The taxpayer just does not have a voice in the equation. The taxpaying community at large just is not involved.

The procedure which is recommended here is completely reversible, completely postponable. It would simply mean that the Government has to decide that next year we want to spend this much money and tell the people, rather than give you this much tax money back. And I think it is a very desirable attribute in any budgetmaking program. This is what you go through in a voluntary organization like ours, it is what you go through in a profitmaking organization, in State and local governments. I think that the Federal Government ought to——

Senator PROXMIRE. It's very desirable for some people.

Mr. DAVIDSON. It ought to have to justify its spending against the availability of the funds. This is the point I am making.

Senator PROXMIRE. Well, I think that is a legitimate point—in view of the history, the recent history, the fact that Federal spending has risen so much less rapidly than State and local spending, the fact that there are so many unmet needs in the country.

Mr. DAVIDSON. Yes. But the traditional government services in America are not provided by the Federal Government. They are provided by State and local governments.

Senator, you have a history here which may be running its course. You see, back before the depression, State and local government took around 10 percent of GNP. By the bottom of the war, it was down to 3 or 4 percent. Now, we have heard a lot of discussion in recent years as if the growth in State and local spending—the disproportionate increase—would go on forever. But actually what is happening is that

State and local spending is about back to its historic level, back to what it was before the depression.

In the meantime, many things which were extremely behind at the State and local level, we are making great strides in catching up. Over the years ahead, it may well be that State and local spending will tend to grow not much more rapidly than the economy. When this is going to come, I don't know. But I think it will come.

Senator PROXMIRE. It seems that your system would put an institutional pressure on Congress and the President not to meet such needs as education, long-term defense, pure research, health, foreign technical assistance, a number of things that most of us feel are desirable, and, indeed, as far as defense is concerned, I think we would all agree that we should not really consider the dollar in that regard, because we have to defend ourselves.

Mr. DAVIDSON. I think it would simply make the Executive justify what he proposes to do in terms of tax costs.

Senator PROXMIRE. What you are proposing is that this Congress, in a sense, put pressure on future Congresses as to the attitude that they might have toward essential services at some future time, when it seems to me that should be left for each Congress as it meets the situation that confronts it.

Mr. DAVIDSON. Our problem now is that past Congresses have put pressure on future Congresses. There are many spending programs, part of our fabric of government today, that, if they were not here, I do not think the Congress would ever put them into effect. This is one of the problems—our past spending programs tend to go on forever.

Representative GRIFFITHS. There is nothing in this program that actually forces the President or the Congress to stop the spending or increase the taxes, or any other thing. Isn't that right?

Mr. DAVIDSON. That's right.

Representative GRIFFITHS. Therefore, what you are really suggesting is there must come a time when the President makes a report on what is going to happen. The President is already making such a report.

Mr. DAVIDSON. That's right.

Representative GRIFFITHS. Isn't he saying on every occasion, and hasn't he said for many years, that this year there will be so much deficit in the budget?

Mr. DAVIDSON. That's right.

Representative GRIFFITHS. Has anybody ever heard of a President that was voted out of office on account of that?

Mr. DAVIDSON. No.

Representative GRIFFITHS. So that, in a budget where even the Manhattan project was discovered by only one member of the Appropriations Committee—only one man in Congress had to have the Manhattan project explained to him, because he recognized that here were billions of dollars that were unaccounted for in that budget.

Mr. DAVIDSON. $2 billion.

Representative GRIFFITHS. There could be something said for having some kind of modest pressure upon the Congress and upon the President to justify some of these things.

Mr. DAVIDSON. I think so.

Representative GRIFFITHS. And it would be a modest pressure only.

Mr. DAVIDSON. I think so. The amount of tax reduction or tax increase for the average citizen isn't as large as we make it out, you see, in these tax changes.

After all, a very large chunk of the earned income of the average taxpayer does not go through to taxable income. So you increase or decrease taxes 1 or 2 percentage points—for a married man who makes $7,000 or $8,000 a year, you are actually doing it against a half or a third of his gross income. It is not a great deal.

I have always felt that—and I think, again, it has been brought out in these hearings—I think you said so, Madam Chairman—I have always felt that the political significance of either an increase or decrease of taxes, per se, has been greatly overrated in American political institutions. I agree with you completely.

Senator PROXMIRE. In your statement, you say:

I believe it would be a mistake to assume that the scarcity of saved capital is a temporary condition.

Well, is there a scarcity of saved capital—scarce relative to what? Isn't one of our problems that we are getting too much investment in plant and equipment? It is an investment which has broken all records by far, and this year is expected to go over $60 billion. Isn't that what saved capital is doing? And doesn't that indicate that in this sense at least, there may be a surplus rather than a scarcity of saved capital?

Mr. DAVIDSON. Senator, I have a table here, "Expenditures on plant and equipment in relation to gross national product," going back to 1948. I am not sure where it appears. I can give you a copy.

Senator PROXMIRE. What's the number of it?

Mr. DAVIDSON. I haven't got the source. I had it mimeographed. Maybe I should just hand that to you.

(The table follows:)

Expenditures on plant and equipment in relation to gross national product

	Gross national product	Plant and equipment	Plant and equipment as percent of gross national product
Period:	*Billions*	*Billions*	
1948	$257.6	$22.1	8.6
1949	256.5	19.3	7.5
1950	284.8	20.6	7.2
1951	328.4	25.6	7.8
1952	345.5	26.5	7.7
1953	364.6	28.3	7.7
1954	364.8	26.8	7.3
1955	398.0	28.7	7.2
1956	419.2	35.1	8.4
1957	441.1	37.0	8.4
1958	447.3	30.5	6.8
1959	483.6	32.5	6.7
1960	503.8	35.7	7.1
1961	520.1	34.4	6.6
1962	560.3	37.3	6.6
1963	589.2	39.2	6.7
1964	628.7	44.9	7.2
1965	675.6	51.8	7.7
1966 (Government estimates)	722.0	60.2	8.4

Mr. DAVIDSON. This table shows the relationship of plant and equipment expenditures to gross national product going back to 1948. You will notice that the estimates for 1966 just put us back to where we were in 1956, 1957, and a little bit below what we were in 1948.

Now, offhand, some people would say: "Well, we were in a capital expenditures boom in 1956 and 1957, and it was an unsustainable boom." But then you have to look at another set of figures which is the utilization of plant.

(The table referred to follows:)

Manufacturing capacity, output, and utilization rate, 1948–65

	Capacity	Output (1957–59–100)	Utilization rate (percent)
Period:			
1948	80	69	86
1949	84	65	78
1950	87	76	88
1951	90	82	91
1952	94	85	90
1953	100	93	93
1954	104	86	83
1955	108	97	90
1956	113	100	88
1957	119	101	85
1958	122	93	76
1959	126	106	84
1960	131	109	83
1961	134	110	82
1962	139	119	86
1963	145	125	86
1964	151	133	88
1965 (preliminary)	160	145	91

Source: Economic Report of the President, January 1966.

Mr. DAVIDSON. Back in 1956 and 1957—in 1956, plant utilization was at 88 percent of capacity, and, in 1957, it was 85 percent of capacity. Now it is 91 percent of capacity.

Now, in this upsweep in growth, prosperity, in recent years, we have climbed from a bottom of 82 percent utilization back in 1961 to 91 percent.

In getting to this point we have had the advantage of the investment which we have made over these years, plus this unused capacity which we are now using.

Generally speaking—I am not an expert in this particular type of figure, but it is generally considered that 92 percent is pretty close to the average of the preferred rate.

Senator PROXMIRE. We are still below the preferred rate.

Mr. DAVIDSON. Just below it. And that's an average—which means in some areas you are over it. But this does mean from here on out, if we are going to maintain high level prosperity and optimum employment conditions, further growth is dependent upon further input of capital.

Senator PROXMIRE. I think this is a pretty devastating argument here against repealing the investment credit. You would be strongly against that?

Mr. DAVIDSON. I would be against that.

Senator PROXMIRE. Because what you show here is that we urgently need more plant investment.

Mr. DAVIDSON. I think the Council of Economic Advisers, in their January report, made an observation that one of the strongest economic factors looking ahead was that there was a projected increase of 7 percent in plant capacity this year. Well, we are talking about real increases—and real product, around 5 percent. So to add a couple of percentage points would seem like a kind of safety valve at this stage in history.

The real problem, Senator, in my opinion, is how are you going to finance this kind of capital formation in the years ahead? We have never had to do it on a sustained basis in the past. And of course we are not going—you see, this long, low gap, this lag in plant and equipment is what we have had, and we have caught up. So it is not a question of 15 percent increase, year after year. The question hereafter is how are you going to maintain a growth from this level which will be——

Senator PROXMIRE. At the same time, it seems to me that any analysis of the statistics would show—and, of course, you selected these—any analysis would indicate that the 8.4 percent, which plant and equipment is now a percentage of gross national product, is very, very high on the basis of even the years you have shown. I suspect if you had gone back further, it would have been even more of a standout. It has been barely that high in 1956 and 1957; it was a tiny bit higher in 1948, which seems exceptional. But in all the other years it was below, and in most years it was far below, in spite of the enormous increase in gross national product, and in spite of the fact that the gross national product is three times as big as it was in 1948.

What these figures would suggest to me is that we are having a big boom in investment in plant and equipment, and also suggests that there is no real scarcity of saved funds. And indeed if you look at the corporations' cash flow, it is most impressive, the enormous increases in depreciation reserves, the great increases in undistributed profits, and so forth.

I am not saying there is anything wrong with that. I am saying, in fact, that it is good. Also, what I am saying is that there is a great deal of savings available to corporations now for investment far, far, far more than ever before.

Mr. DAVIDSON. There is a theory—and again I have only skimmed papers and I cannot talk about it accurately—but there are papers floating around now which indicate that the increased value of depreciation, capital consumption allowances, that had been built in by the 1954 changes and other things, has about run its course, and hereafter, in terms of the total capital formation job, capital consumption allowances, under our present system, are going to be a declining proportion.

Senator PROXMIRE. You don't have to go back to 1954.

Mr. DAVIDSON. 1962—guidelines were very, very valuable.

Senator PROXMIRE. We had the investment credit, the cut in the corporation income tax, all these things have been helpful, plus the fact that you have got a stock market which is so much higher, so that you can borrow—you can get money by floating common stocks much more readily than before.

Mr. DAVIDSON. But in the absence of these things, we simply could never have gotten to this point.

Senator PROXMIRE. I would agree with that. But still your argument that scarcity of saved capital is a fact is pretty hard to establish under the present circumstances.

Mr. DAVIDSON. Well, if you want to increase capacity from 5 to 6 or 7 percent a year, over the years ahead, it is going to take the kind of investment that we are now doing—this general relationship. I don't mean exactly 8.4 or 7.8 or anything else. But you have got to have investment in this range, it would seem to me, of GNP in order to grow adequately, and to keep the unemployment level down.

Senator PROXMIRE. The reason I raised this question is that I am wondering about your argument a little further, where you talk about—you complain about the failure of tax rate to be reduced in the middle and higher income brackets, and corporate income. It seems to me once again if you go back to 1954, when we had a tax reduction that was almost exclusively on corporation income, 78 percent——

Mr. DAVIDSON. In 1954? That was the termination of the excess profit tax.

Senator PROXMIRE. That's correct. Nevertheless, that was——

Mr. DAVIDSON. The corporate rate was not touched at all.

Senator PROXMIRE. The corporate rate was not touched. But the undistributed profits tax was repealed.

Mr. DAVIDSON. That is a tax that should never have been there to begin with.

Senator PROXMIRE. Maybe so, but it was repealed.

Mr. DAVIDSON. I could never look on that as tax relief. I consider that as a removal of something that just did not have any place in the tax structure to begin with. A tax system that goes up to 80 or 90 percent, to get it down to a flat rate of 52 percent——

Senator PROXMIRE. If you turn this around, as some of the members of the Finance Committee—I am not a member—but Senator Gore tells me what he did when Henry Ford came in was to ask him how much his income after taxes was increased by the 1964 tax cut, and it was increased something like 100 percent. This is true of people in the top brackets—whereas the people in the lowest income bracket had a very small percentage increase in their income after taxes.

If you look at it that way, it seems to me it is not so clear that this last tax cut was discriminatory against the well-to-do.

Mr. DAVIDSON. Well, we can look at the tax structure two ways. Obviously, a person who makes more money has superficially a greater ability to pay taxes. But if you look at taxes from the standpoint of the economic effects, it may be better for everybody to pay a fair share, and not to put extra burdens on the processes of capital formation savings and investments, because it is the capital itself, and incentives which have created our economic society, which provide a greater hope for the disadvantaged people. This idea of taxes, of high taxes, on the middle and higher brackets, and on business, being a way of favoring low-income people is one of the things that we just have to get out of our literature and our thinking. Eventually, we have to get it out of political discussion, it would seem to me.

These taxes hurt people because they diminish the economic potential of the Nation.

Senator PROXMIRE. I think you can make a strong argument that way. But nevertheless, practically every economist that I read, that testifies, argues that our trouble is inflation in the investment area, that your savings are sufficiently high so that people are investing too much in plant and equipment, and too rapidly. We want this over the long pull, but we don't want as much of it, as big an infusion, all at once.

Mr. DAVIDSON. I may be wrong, but as I have listened to them, it seems to me they are saying there is too much demand in our economy, and this demand is pressing against capacity, which makes business desperate to expand in order to meet current needs. The problem here could be turning off demand, consumer demand, and Government demand, and not in reducing business capacity to serve demand.

Senator PROXMIRE. No—I think if you look at the total economic criteria, you will find by far the biggest increment, the biggest increase, the most sensational and dramatic, has been in investment in plant and equipment.

Mr. DAVIDSON. There is no question about it. But by the same token, 3 or 4 years ago the biggest lag was in this area. This increase is essentially one of catching up on the lag which had developed since 1957.

Senator PROXMIRE. But this has an accelerating effect on the economy. This is the area where you are having your price difficulties.

Mr. DAVIDSON. Well, nevertheless, investment in plant and equipment is both the means for meeting present and future demand, and it is also a means for doing it most efficiently—making best utilization of labor, and so forth. It is hardly an expendable element in the economic equation. What we need to do is reduce the demands made for the products of industry, not to reduce industry's capacity to create products.

Senator PROXMIRE. Let me ask you one other question—at least in one other area.

You feel that the present situation, the present rate of capacity, the relationship between demand and supply generally is about right, is satisfactory? Do you think it can be sustained?

Mr. DAVIDSON. Let me——

Senator PROXMIRE. The reason I asked that—let me go on a little bit. I am inclined to think there are many, many values in having an economy boil along as hard as it can go, as long as there is not substantial increase in prices. As a matter of fact, I think we can maybe even pay a little price in some price increases in view of the immense values in this.

When you recognize what is really helping the people who are unemployed and who have no skill, it is, in part, the Government's manpower training, which I wholeheartedly support, but much more important is the fact that employers all over the country desperately need trained workers, so they are training them.

Mr. DAVIDSON. That's right.

Senator PROXMIRE. And they would not do this if it were not for the fact that they desperately have to have them, the demand is pressing against their capacity, and consequently they are willing to go out and hire and train people. These are people who are going to be trained the rest of their lives. They are not going to be unskilled workers any more. They will have something to sell. And that's a great, great thing for the economy. It is something that Government itself could not possibly afford to do.

This is why I think that we ought to recognize the real value in this situation, and not complain about 3.7 percent unemployment as being inflationary, and be very, very anxious to keep this up as much as we possibly can, as long as we don't move into a runaway inflation.

Mr. DAVIDSON. Well, I agree with you completely, Senator, on the value of high-level growth as a basic way to solve an unemployment problem, in giving people maximum opportunity in society. There is no question about it. At what level you have to pay a price of inflation for doing this is a question. Of course we cannot get away from the fact that the Government economists felt the interim goal of 4 percent was just not just an accidental thing—this was the general zone in which they thought to go any further might create inflationary pressures. There might be a little change in this philosophy now. But this was the original concept, 4 percent—you could afford to stimulate your economy down to 4 percent, just as a concept. Private economists mostly felt this was rather optimistic, you know. They were more inclined to say 5 percent—pushing it down from 5 to 4 you probably create inflationary pressures.

Senator PROXMIRE. Mr. Martin said 2 or 3 years ago if we got down to 5 percent, we would have inflationary pressures.

Mr. DAVIDSON. I think it has happened. But it was Buchanan who said here last week, you have to remember whatever we do, if you stimulate you may create inflation, but you put people to work. If you destimulate, you may take some of the heat off inflation, but there are people who no longer have a working opportunity. This is the way it works——

Senator PROXMIRE. And under present circumstances, you do feel that the situation is such that you would not, do not, advocate a tax increase?

Mr. DAVIDSON. Because if it should be done, it should have been done already, Senator.

Senator PROXMIRE. No. 2, you have an overall proposal for a more responsible budget, as you put it, but you are not urging it on the Congress?

Mr. DAVIDSON. This is an idea to be presented here. We have no program at this time to promote or sell this kind of a plan.

Senator PROXMIRE. So your position, as I understand it, is one of alertness on the part of Congress and a sensitivity to what is going to happen in the future, but you are not advocating any major changes in fiscal policy?

Mr. DAVIDSON. At this stage, you mean?

Senator PROXMIRE. Either way.

Mr. DAVIDSON. Perhaps I should explain that when this invitation came, we were hard at work thinking about this very problem. We had been because of Secretary Fowler's and Secretary Surrey's interest. Secretary Surrey, for example, was at our committee meeting back in early February, and impressed on us the importance of looking at this. So we had just begun to break through with what we considered to be the essential elements of the plan when we were notified that Mrs. Griffiths was going to hold these hearings.

So actually we had intended to put our new thinking into our policy channels in NAM.

Well, we just kind of rushed the job in presenting it to you, to be as completely responsive to your hearings as we could.

Senator PROXMIRE. Well, as the chairman said, and I agree, you are a man with a plan, and it shows. It's very helpful. Thank you.

Mr. DAVIDSON. Thank you.

(The following letter was later submitted by Mr. Davidson:)

NATIONAL ASSOCIATION OF MANUFACTURERS,
March 29, 1966.

HON. WILLIAM PROXMIRE,
Congress of the United States,
Washington, D.C.

DEAR SENATOR PROXMIRE: This is in response to your letter of March 23, requesting comment for the record on the advantages and disadvantages of the value-added tax for the purpose of stabilizing the economy.

Until the hearings I had not given thought to this question. It has always seemed to me that we exaggerate in this country the advantages of income taxation and understate the advantages of indirect taxation. A broad-based indirect tax, such as value-added, would permit more moderate rates of income tax. This is a desirable end in itself, but such a tax also would make it easier for the Government to meet emergencies requiring large increase in revenues. It would be less disturbing to draw upon three tax methods than two, and the increases would start from lower rate levels.

I am not so certain, however, that a value-added tax would qualify as a particularly good means for stabilizing the economy where the trend involved is more cyclical than a result of a fiscal emergency. Specifically, in an inflationary period like the present, a modest increase in value-added taxation would have an immediate impact on consumer demand only as it was immediately reflected in higher prices. Whether the tax were immediately passed through at a particular time might be determined more by money and credit policies than by tax policy.

This is as far as my thinking goes at the present time. I hope it does not prejudice the case for a broad-based indirect tax, such as value-added, to balance out the tax structure for the long pull. I believe a better balanced tax structure would improve our fiscal capacity to cope with all situations, come what may.

Sincerely yours,

JOHN C. DAVIDSON.

Representative GRIFFITHS. I would like to ask you this, What do you consider any signs of downturn in the economy right now?

Mr. DAVIDSON. I don't know that there are signs of downturn with which I am familiar. I have read in the last couple of days there was a queasy situation in housing. It seems to me this is about the only negative economic indicator I know of. I have not studied the new indicators. I should have and maybe I could respond to it.

I am impressed by the fact that we did have a $6 billion increase in social security taxes on the 1st of January which cannot be laughed off. I am impressed by the fact that the Fed apparently is making it pretty tough to borrow money. I am impressed by the fact that the national economic accounts budget was supposed to run only a $2 billion deficit this year and the President has projected a $500 million surplus next year.

In other words, that would be a $2½ billion turnover there.

My attitudes are based more on the overall things than any particular indicators.

Representative GRIFFITHS. So unless you really had substantial increases in Government spending, you feel the crest of the danger has passed from inflation?

Mr. DAVIDSON. Well, I don't know about the crest of the danger. I think that the inflation we are bound to get out of what happened is taking place now, and by the time you can increases taxes, I don't think it would prevent it from taking place.

But if it were ill timed in relationship to the conditions coming up subsequently, it could be deflationary.

Again, I think that the thing that we should be very sensitive about is wanting to turn off what some people might call a capital goods boom. I don't think it is that. I think we are back to about the relationship we should want to maintain. I would be very, very cautious about doing anything which might turn the trend down. I think that would be a very dangerous thing to do. I think we need to have this figure growing, not leveling off and going down.

Representative GRIFFITHS. I would like to thank you for coming here.

Senator PROXMIRE. Could I just follow up on that, because I think the chairman has raised an interesting point.

After all, the housing is less than just queasy. These was a sharp drop last month, in February, 17 percent below January, which was low, and well below what it was the previous year, which was not adequate. Construction has so often been the kind of bellwether of the American economic growth and expansion.

There has also been a leveling off in inventory acquisition, an indication that inventories would not increase, and of the absence of hoarding.

There has been a leveling off of profits. I understand the last several quarters they have not increased.

This is very significant.

There is also a $6 billion tax increase by the Congress that is being signed by the President, and an increased flow of manpower into the labor market somewhat exceeding the estimates made by the Bureau of Labor Statistics and others. So that I think all of these factors suggest that the inflationary threat is not as great as it was.

Mr. DAVIDSON. We have a rather amazingly well balanced economy to have gotten to this level. You are indicating some things which are not inflationary, could be deflationary, at least leveling out. It is a very difficult judgment to say that we are part of any continuing inflationary cycle.

Senator PROXMIRE. Not to speak of the stock market.

Mr. DAVIDSON. That's right. It has not always been right but it is not a bad indicator at all.

Representative GRIFFITHS. I would particularly like to thank you for coming, because I do feel that you have presented a plan, and to me it is quite a reasonable plan.

Mr. DAVIDSON. Thank you.

Representative GRIFFITHS. I don't even feel that you are to be criticized for not making all types of suggestions for cutting expenditures. I feel quite certain that you and every other person with any judgment hopes that we will cut out the unnecessary and wasteful expenditures of Government.

But I think also that if you would have looked at the budget carefully, you will find that in those spots where the cuts have been made, they are the very ones that are most apt to be put back by this Congress.

Therefore, it is rather impractical for anybody to come in with stars in their eyes and say that we really are going to cut the budget in any large way.

I think that your plan of a tax decrease for a long period of time has really some great assets. I would have one argument to begin with on who is going to get the cut. Out of that argument, I think, should be excluded the closing of loopholes, because I personally feel that as a practical matter the thing that happens is that new loopholes are opened. So it should be discussed only from the point of tax cuts. I think if they were put into effect over a long period of time, with very modest decreases, with your suggestion of either increasing them periodically, if it were necessary, or decreasing them, that it would have a real advantage.

Much as I deplore, unfair as I think it was, to make one or two industries bear the excise tax increase, I still think that it had some merit to have that tax left there and an ability quickly to increase it.

So that I think your plan holds out this hope on an income tax situation.

I think it would get rid of much of the political argument.

Senator PROXMIRE. If the chairman will yield at that point.

Representative GRIFFITHS. I will in just 1 minute.

But I feel that if there is any feeling on the part of anyone that the result of this would be to curtail expenditures of the Federal Government, I think they are quite wrong. I don't think it would curtail the expenditures of the Federal Government. I think it might give an argument to some people who wanted to use that argument that the Government was wrong, but I think that argument would fall just as the argument on the national debt has fallen.

Used repeatedly, it would, in the end, amount to nothing. Although I would hope that there would be some built-in opposition to expenditures that were useless and wasteful, and that we might be able to tolerate that.

Therefore, I want to thank you again. I think you did present a plan and personally I think it should be considered.

Mr. DAVIDSON. You are very generous.

Representative GRIFFITHS. Thank you very much.

Senator PROXMIRE. I certainly join the chairman in commending you.

But I would like to state the great difficulty with your plan, Mr. Davidson, is that it would deprive future Congresses and the President of much credit for cutting taxes. We like to have this tax cut in election years. It's a fact of life. If you have a long-range plan the voters says, after all, you Congressmen didn't do that. That was the good old 89th or 90th Congress that cut our taxes, it's going to be a lot less appealing for future Members of the House and Senate and for future Presidents. In the future, all Members of Congress and the President could do is increase taxes, stop cuts, under your plan.

Furthermore, while the chairman may well be right, that this would not result in a reduction of expenditures, if it did not result in a reduction of expenditures, just think of the deficits we are going to have in the size of the national debt.

Representative GRIFFITHS. Necessary expenditures. It would not reduce necessary expenditures. But there would be some expenditures that it would make unnecessary.

I might say to you that Congressman Mills told me that the person who first had the judgment to see that as a result of decreased taxes you would have increased demand and could level off some expenditures, was Dan Reed of New York. He was the person who made the first argument on this floor. And naturally, it was regarded as purely political.

Without objection, I will include in the record at this point the statement of the National Federation of Independent Business.

(The statement follows:)

NATIONAL FEDERATION OF INDEPENDENT BUSINESS,
San Mateo, Calif., March 18, 1966.

Hon. MARTHA GRIFFITHS,
Chairman, Subcommittee on Fiscal Policy,
Joint Economic Committee,
U.S. Capitol Building,
Washington, D.C.

DEAR MADAM CHAIRMAN: In connection with your hearings on the possible need for and design of temporary tax changes for economic stabilization we would like very much to submit the attached statement and request that it be included in the official hearing report.

With best wishes,

Sincerely,

GEORGE S. BULLEN,
Legislative Director.

STATEMENT OF GEORGE S. BULLEN, LEGISLATIVE DIRECTOR, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

POSSIBLE NEED FOR AND DESIGN OF TEMPORARY TAX CHANGES FOR ECONOMIC STABILIZATION

The 211,000 small business members of the National Federation of Independent Business are vitally concerned with the current study being conducted by your committee on the possible need for and design of temporary tax changes for economic stabilization.

We are a national organization with members in all phases of commercial enterprise and the professions. These members are a represenative cross section of the Nation's entire business community at the retail, wholesale, manufacturing, servicing, and professional occupational levels. Our policies are determined by direct poll of the members by mandate ballots—the majority vote on each issue being the deciding factor. Since our large membership is widely distributed in all the States and is so representative by type or trade of all of the Nation's 4.7 million small businesses, we know you will wish to consider their views on the subject before you. Shown below is a question on which our members were polled, the arguments given them, both "pro" and "con," and the results:

2. Permit President to change tax rates.

Should Congress permit the President to make temporary changes in tax rates as he sees fit, lowering them in hard times, and increasing them in good times?

2. Argument for permission to change tax rates: Flexible tax rates could be a potent weapon in fighting recession. When times get poor, rates could be cut to free more money for spending with private business. When recovery sets in, they could be adjusted upward to cover Government spending and perhaps yield a little extra to cover accumulated deficits. Naturally, power to make changes would have to rest with the President who could make instant decisions (Congress is not always in session). Changes would be kept, of course, within limits set by Congress and always subject to congressional review.

2. Argument against permission to change tax rates: Granted the wisdom of using tax changes to fight recession, the fact remains power to make changes should rest with with Congress and it alone. Our Constitution places control of

the public purse with the Congress. It did so, and does so, to protect the freedom of every citizen. After all, the power of the purse, the power of taxation, is the power to run the country. It does no good to argue that Congress is sometimes out of session. With radio, telephone, and telegraph, with jet airplanes, Congress could convene within 24 hours in any emergency.

2. Permit President to change taxes:

	Percent
For	15
Against	83
No vote	2

In addition to policy-setting polls, we conduct yearly factfinding surveys and, at the request of Members of Congress or committees, special surveys. In one section of our recently completed year-long, factfinding survey, "Small Business—The Nation's Largest Employer," our members were asked if they had expanded during the past 12 months, and how many (if any) new job openings resulted. Seventy thousand and seven hundred responses were received. The survey revealed that during the past year, projecting our representative expansion rates to the entire American small business community, that as many as 1.5 million small businesses expanded, creating in the process over 3 million new job openings. Analysis of this survey shows that of the respondents who expanded their business operations, the great majority found the 7-percent investment credit to be the greatest stimulant to expansion or modernization. These expansions, in turn, were responsible for the creation of new job openings and the present low level of unemployment. It is important to bear in mind, then, that the 7-percent investment credit has proven itself invaluable, not only to plant modernization and expansion, but possibly even more importantly to increasing employment. We therefore, urge that should your committee recommend tax changes, the 7-percent investment credit be left intact. We prefer to have our Nation's work force fully employed, and at the same time prevent inflation, by insuring that our plants can produce a sufficient volume of goods to meet the increased demands of a full employment buying capacity.

Representative GRIFFITHS. At this time we will recess until 2 p.m.

(Whereupon, at 11:15 a.m., the hearing was recessed until 2 p.m. on this same date.)

(The material included here was subsequently submitted by the witness. Reference, p. 187.)

NATIONAL ASSOCIATION OF MANUFACTURERS,
March 29, 1966.

Hon. MARTHA W. GRIFFITHS,
Chairman, Subcommittee on Fiscal Policy,
Joint Economic Committee,
Congress of the United States, Washington, D.C.

DEAR MRS. GRIFFITHS: During my appearance on March 22, Senator Proxmire asked if NAM had pointed out any specific areas where Federal spending could be cut, and I replied there was an association recommendation for cutting the 1967 budget from $2 to $3 billion. He then asked that I provide the committee with information as to where this reduction would be, which is the purpose of this letter.

The recommendation, as initiated by the association's Government expenditures committee, and adopted by its board of directors on February 16, 1966, is attached. The fourth paragraphs recounts the rise in the costs of programs involved in the concept of the Great Society from fiscal 1965 to fiscal 1967; proposes that the 1966 figures be leveled out below that budgeted ($13.1 billion); and recommends that the cost for 1967 (projected at $15.1 billion) be held below the reduced 1966 level. The $2 to $3 billion range is derived from these data.

I am also attaching a statement providing background for this policy recommendation, and a more elaborate piece which was prepared for the information of our Government expenditures committee which provides detail on the spending programs involved. I have no reason to ask that either or both of these be included in the printed hearings, but there is no objection if you and Senator Proxmire would like to do so.

Again, may I express my appreciation for your thoughtful consideration of my views.

Sincerely yours,

JOHN C. DAVIDSON.

RECOMMENDATION OF THE GOVERNMENT EXPENDITURES COMMITTEE ON THE FEDERAL BUDGET FOR 1967

(Adopted by the NAM Board of Directors, February 16, 1966)

In 1967 Federal budget calls for both military build-up in Vietnam, and a continuing growth in domestic spending. The result is a proposed deficit of $1.8 billion.

NAM believes that priority should be given to our military commitments, as the President proposes.

It further believes that, in the face of the uncertainties of the requirements for military escalation and the growing concern with inflation, spending for domestic programs should be held at or below current levels. This is particularly so of the programs involved in the concept of the Great Society which was conceived when economic conditions were at a lower level than at present.

The total costs of these programs are sharply increasing. They rise from $8.7 billion in fiscal 1965 to an estimated $13.1 billion in fiscal 1966, and with a projection of $15.1 billion for fiscal 1967. The executive branch should begin immediately to level out and reduce these programs so that the actual costs resulting for 1966 will be well below those now planned. The 1967 costs should be held below this reduced 1966 level. If the budget estimates in other spending areas hold true, these economies alone would result in budget balance in 1967, assuming presently projected revenues are realized.

The Federal budget for 1967 is shaped under circumstances of general economic well-being: economic growth, employment, the utilization of productive activities are all at high levels. The economic outlook is optimistic, but inherently inflationary.

These are the conidtions under which budget balance should be achieved. And it should be accomplished through reductions in Federal program costs.

BACKGROUND FOR POLICY PROPOSAL OF NAM'S GOVERNMENT EXPENDITURES COMMITTEE ON THE FEDERAL BUDGET FOR 1967

The President has called his budget for 1967 a responsible fiscal program, and he has shaped it around three major goals—

Meeting our military and international commitments;

Moving closer to our Great Society goals;

Strong but noninflationary economic growth.

The budget message and the presentation of expenditure figures indicate that the President has imposed restraints on programing and spending, and that this has been done not only to accommodate rising defense costs, but to exert a moderating influence on inflationary potential.

This attitude is not wholly substantiated by study of the components of the budget.

It is true that some programs have their 1967 spending reduced from 1966. But most of these depend on proposed legislation not yet passed by the Congress. Other reductions are also tenuous, depending on future farm crops, increase of special receipts, etc. These reductions, based on uncertainties, may or may not help offset the larger and more assured spending increases in both the defense and domestic sides of the new budget. Vietnam costs are an obvious increase. Furthermore, there is actually a very large increase (larger than budget expenditures show) in social welfare programing, personnel—especially in the higher grades—and requests for spending authority, with requests for spending authority running well ahead of presently estimated expenditures.

FUNDAMENTAL PRIORITIES

There are two policy issues for consideration:

1. Military requirements and the containment of inflation are of primary importance, and

2. In the face of the uncertainties of the full demands of defense and the rising concern with inflation, the increase of spending for the Great Society is clearly of secondary value.

As an appropriate framework for congressional appraisal of the President's requests for 1967 spending authority, Chairman George Mahon of the House Appropriations Committee offers pertinent advice:

What we need, then, in my judgment, is to draw a sharper distinction between our needs and our wants. A need is a necessity; a want is a desire. And as a general proposition of principle, I think it best for the health of the Government and the public good that all of us ought to find ourselves in some perpetual state of dissatisfiaction about public spending at all levels of government, no matter what the size of the budget, but with our perspectives in good focus.

MEETING OUR DEFENSE COMMITMENTS

The administration's cost reduction program and establishment of priorities within the defense budget have permitted current planning for Vietnam to be held at a $10.4 billion expenditure rise since 1965, and a $5.8 billion rise since 1966. Because this is so far a relatively modest outlay in terms of the cost of warfare, and because there is no question but that we will provide whatever is necessary for the now unknown ultimate level of the Vietnam commitment, there is a need for much more substantial restraint in nondefense spending than that undertaken by the President.

MOVING TOWARD THE GREAT SOCIETY

Adjusting to reflect various anticipated transfers from and offsets to budget expenditures as such, the total outlay, or gross level of costs, for all administrative budget domestic programs is about $9 billion more than the resources actually applied to these programs in 1965, and only $4 billion more than now contemplated for 1966.[1] Except for a large current increase in interest and smaller increases for tax collection, veterans care and natural resources, these increases are mainly for programs that can be classified under the Great Society concept. Here are the total program costs for the Great Society:

	Billions
1963	$6.1
1965	8.7
1966	13.1
1967	15.1

The framework of circumstances under which the Great Society was conceived 2 years ago was economic lag, unused productive capacity and unemployment. These do not exist today. Where the Government's conscious aim then was frankly stimulative, its expressed concern now is fiscal restraint. The Great Society would have difficulty in being initiated today under present economic circumstances. And there is grave question that it should be escalated under such circumstances.

Directing programs to the needy is one thing. And the President should be commended for his realistic proposal to establish restrictions on some school aid programs. On the other hand, the widening of eligibility requirements for welfare programs, and other redefinitions of the needy to expand the base of Great Society programs, should not have the priority claim on Federal funds that the President is giving them. Furthermore, massive expenditure increases of new, often experimental programs, without adequate demonstration of their effectiveness and value, only serve to secure the existence and financing of unproven projects.

NONINFLATIONARY ECONOMIC GROWTH

The President has said he would "not hesitate to ask for further fiscal restraint on private spending" if economic demand presses beyond productive capacity. NAM believes that a responsible sharing of measures to contain the inflationary potential must be taken by business, labor, Congress, and the administration if containment is to be effective. Adjusting the 1965–67 figures to reflect the various transfers and offsets to spending which cut down the administrative budget expenditures, there is a $20 billion increase in the total outlays for budget programs in the last 2 years, $8 billion since 1966. This has expansionary overtones which certain budgetary techniques tend to obscure. The deficit

[1] See appended work data for computations.

positions of both the administrative and cash budgets, for example, are computed well over $4 billion lower than they would be except for anticipated offsets to expenditures from receipts of sales and Federal loans. To the extent that this operation in the credit market would lead to an expansion of bank reserves, it would raise the inflationary potential. The same can be said to the extent that the proposed speedup of corporate tax payments would increase bank loans to corporations.

The most direct way to assure that the Government is not contributing to inflationary influences is for a meaningful reduction to be made in the Federal budget for 1967. The full employment budget concept which calls for increasing expenditures when unemployment is high, does not also call for increasing expenditures when unemployment is low. When there is relatively full employment both of the labor force and of productive capacity substantial increase of spending and particularly of deficit spending, would undoubtedly contribute to inflationary influences.

[Appendix to "Background for Policy Proposal on the Federal Budget for 1967"]

Work data on total outlays in the Federal budget for 1967

[In millions of dollars]

Approximation [1] of total outlay, or gross expenditure level, for domestic budget programs	1965	1966	1967
For total outlay combine—			
1. Budget expenditures [1]	96,507	106,428	112,847
2. Gross expenditures of proposed revolving funds		+356	+486
3. Offsets to expenditures by sales of participation and direct loans	+1,564	+3,307	+4,479
4. Expenditures transferred to highway trust fund			+110
Approximate total outlay [1]	98,164	110,191	118,282
For domestic programs deduct—			
Functional expenditures for military, DOD	−46,173	−52,925	−57,150
Military assistance	−1,229	−1,275	−1,150
Space	−5,093	−5,600	−5,300
Foreign economic aid	−2,440	−2,194	−2,368
Participation sales, Exim Bank	−574	−1,035	−1,000
Food for peace	−1,641	−1,701	−1,539
Approximate total, domestic outlay [1]	41,016	45,461	49,775

[1] There would be a somewhat higher level of outlay if total program costs for the entire budget were computed from appendix detail and used herein instead of the readily available totals of budget expenditures.

SUPPLEMENT NO. 2 TO HIGHLIGHTS ON THE 1967 FEDERAL BUDGET

INFORMATION FOR NAM'S GOVERNMENT EXPENDITURES COMMITTEE, FEBRUARY 10, 1966

SOCIAL ACTION AND AID PROGRAMS

The heart of the President's budget for nondefense purposes is what he calls the Great Society programs—those dealing with social and economic change and benefits.

The President himself, in his budget message (and pointed up as "the changing Federal budget") gives the budget expenditure figures for his own package of programs directed toward the Great Society for 1964–67. Using his categories, we have tallied the parallel requests for new spending authority, and totals for both for 1963. They are as follows:

[In billions]

President's package	1963	1964	1965	1966 estimate	1967 estimate	Change, 1967 from 1963
Budget expenditures	$6.0	$6.7	$7.3	$10.8	$12.9	+$6.9
New spending authority	7.4	8.0	11.2	15.8	16.8	+9.4

It is clear that future spending will rise in these categories, since the requests for authority to spend are well above expenditure estimates; the total authority requested for these particular years is $15.5 billion in excess of the expenditures. This is forward funding 35 percent higher than expected spending, and for programs with comparatively little long-term commitments in them.

The purpose of this section is to present the package of individual programs which, in NAM's judgment, fits into a realistic definition of the Great Society and to show the total program costs for these programs.

Both in the selection of programs for inclusion, and in selection of gross cost figures, data are taken from detail in the budget itself. Our definition will differ in some respects from the President's, and from others that might be justified; but our choices are consistent in pattern. Our cost figures are gross figures, before financing from any source is taken into account; and, therefore, differ from budget expenditures which are net figures. Since items of financing may change for any given program, these gross figures are the best indication of the scope of the program.

The President's package of programs is more comprehensive, and less exact, than the package we would wrap into the concept of the "Great Society." Our definition is explained later, but here, for contrast with the President's package, we give totals for several concepts based on our definition.

For our package

[Billions]

	1963	1965	1966 estimate	1967 estimate	Change, 1967 from 1963
Budget expenditures	$5.0	$7.1	$10.2	$10.5	+$5.5
Total program costs	6.1	8.7	13.1	15.1	+9.0
New spending authority	6.1	9.5	13.2	13.7	+7.6

Of the three totals we show for our package, "budget expenditures" and "new spending authority" are familiar concepts. "Total program costs" is the gross figure. In 1965 and 1966, new spending authority is somewhat higher than total program costs as might be expected. Because of the application to these programs of forms of financing not previously used—particularly the sale of participations in Government loans—this situation is reversed in 1967.

As is shown later, some of the figures in our "total program costs" are not completely comparable. But our purpose is to be illustrative and realistic—not to reconcile the complications of different accounting concepts. We believe the totals presented here (and the details shown in the tables) indicate the full scope of Federal programing for "the Great Society" more adequately than budget expenditure alone.

The concept of a "Great Society" has captured the imaginations of many people. However, the definition has, in the past, been very general. People "had the feeling" that it had to do with the alleviation and prevention of poverty, the promotion of education and health, the improvement of environments. The closest thing to an official definition is found in President Johnson's 1967 budget message:

"* * * combined expenditures on major programs directed toward the aims of the Great Society—in health; in education; in the war on poverty; in manpower training; in housing and community development * * *."

An attempt to identify the individual programs included in the President's listing made it apparent that all programs from the following categories of expenditures had been included:

Housing and community development—including aid to private housing and the Federal contribution to the National Capital region.

Labor and manpower—including the total budget for the Department of Labor and such other agencies as the National Labor Relations Board, the Federal Mediation and Conciliation Service, etc.

All welfare and health—including the total budgets for the Public Health Service and the Food and Drug Administration.

All assistance to educational organizations—including the Library of Congress and the Smithsonian Institution.

The President's combination appeared, however, to omit the Appalachian assistance program and the new economic development programs, as well as certain rural development and planning programs—which are all intrinsic parts of the "Great Society" concept.

In an atempt to further refine the programs involved in the "Great Society"—and to estimate the resources being applied to them we have selected specific programs on this basis:

(1) The traditional programs of a welfare nature—the nucleus of the "Great Society."

(2) New programs initiated during the 1960's for purposes of social action and aid.

(3) Programs expanded or modified in the past 5 years to reflect the "Great Society" concept.

Therefore, the training programs of the Manpower Administration of the Department of Labor are included: the entire Department is not. Recent vocational education expenditures are in our list; those financing the 1917 legislation are not. The environmental health programs of the Department of Health, Education, and Welfare are included; the National Institutes of Health are not. These choices do not reflect the judgment that one group of programs contributes more to the welfare of our society than the other. Rather, they reflect the judgment that one group, rather than the other, includes the new emphasis which has come to be called the "Great Society."

Determining gross program costs

To offer a picture of the total resources called for by the scope of programs devoted to social action and aid, budget expenditure figures as such are not adequate. These are in many cases "net" figures, after application of other resources and financing available. A more inclusive concept is "total obligations," that is, all the commitments to be made in a given year which will ultimately have to be paid for. Thse, however, include some commitments for expenditures in other years. Therefore, as first choice for the purpose here, the budget data used are the figures for "total program costs, funded." This figure is given in the fundamental details of program and financing. It is the base, the scope of program needs, on which the requests for new spending authority are based. It appears to be a reasonable parallel to the "gross expenditure" figures used in public enterprise fund accounts. Thus, in our tables on "Great Society" programs we have used "gross expenditures" for all enterprise fund programs, and for regular budget funds, "total program cost" where it is available, otherwise "total obligations."

This is pointed up in our summary tables by the two sets of figures—ours for total program costs, and the budget's for its own expenditure figures, both for the same programs, of course.

The summary tables indicate the separate categories we have set up for our pattern of Great Society programs, and the tables for each of these seven categories show, in turn, the specific program items included in the category.

The detail and totals are all shown for the years 1963, and 1965 through 1967. The year 1963 was chosen as the base year because, as the last fiscal year over which President Johnson had no primary influence, it is appropriate for contrast and comparison.

"The Great Society," summary of administrative budget expenditures [1]

[Millions of dollars]

Program identity	Actual		Estimated		Percent change 1963-67
	1963	1965	1966	1967	
I. Welfare-oriented	3,309.2	4,117.4	5,711.3	6,095.0	+84.2
II. Education	581.8	990.6	2,287.7	1,640.4	+182.0
III. Health	417.4	492.9	549.9	928.0	+122.3
IV. Community development and renewal	236.4	421.5	504.8	618.1	+161.5
V. Area and regional economic development	101.4	398.7	242.0	314.6	+210.3
VI. Manpower training and employment opportunities	156.1	372.2	518.1	619.6	+297.0
VII. Advancement of science and the arts	206.4	308.9	366.5	433.4	+110.0
Administrative budget expenditures total [1]	5,008.7	7,102.2	10,180.3	10,649.2	+112.6
New spending authority	6,139.7	9,532.7	13,248.3	13,742.5	+123.8
Total program costs [2]	6,062.7	8,662.5	13,109.2	15,055.1	+148.3

[1] As explained in the text, these figures include many "net" components, and do not reflect the total cost level of programs. See following table.

[2] See following table.

"The Great Society," summary of program costs [1]

[Millions of dollars]

Program identity	Actual		Estimated		Percent change 1963–67
	1963	1965	1966	1967	
I. Welfare-oriented	3,853.2	4,838.8	6,455.6	7,245.8	+88.0
II. Education	602.3	1,235.4	3,167.9	3,692.7	+513.1
III. Health	495.4	746.6	1,159.2	[1] 1,333.4	+269.2
IV. Community development and renewal	422.6	696.1	791.5	[2] 1,007.7	+138.5
V. Area and regional economic development	225.5	291.9	368.0	461.6	+105.7
VI. Manpower training and employment opportunities	160.9	437.7	671.0	770.7	+379.0
VII. Advancement of science and the arts	302.8	416.0	496.0	543.2	+79.4
Program costs total [3]	6,062.7	8,662.5	13,109.2	15,055.1	+148.3
Budget expenditures: totaled for the same items [4]	5,008.7	7,102.2	10,180.3	10,495.6	+109.5

[1] Includes $115.1 million for new program.
[2] Includes $5 million for new program.
[3] These figures do not compare with budget expenditures; they are the "gross" levels of resources called for by program scope.
[4] From preceding table.

TABLE I.—*Welfare-oriented programs*

[Millions of dollars]

	Actual		Estimated	
	1963	1965	1966	1967
A. Total program costs, nonloan programs:				
1. Grants for public assistance and health services for aged	2,706.8	3,168.0	3,603.0	3,746.4
2. Grants for maternal and child welfare	76.3	121.2	187.0	228.9
3. Juvenile delinquency and youth offenses	5.6	11.4	6.8	8.2
4. Cooperative research or demonstration projects	1.1	1.7	1.9	2.5
5. Special milk program	94.4	98.7	100.0	21.0
6. School lunch program	169.1	191.1	202.0	183.0
7. Food stamp program	20.2	35.2	100.0	150.0
8. Rural housing for domestic farm labor		3.0		3.0
9. Rent supplement program				3.0
10. Low income housing demonstration	.1	1.3	2.0	2.0
11. Office of Economic Opportunity		187.8	1,177.0	1,637.0
12. Foster grandparents program (OEO)		(1)	.2	.2
Salaries and expenditures:				
13. Bureau Family Services	3.8	5.5	7.1	8.5
14. Children's Bureau	2.9	4.4	4.9	5.3
15. Office of Aging	.5	.6	7.5	10.3
16. Office of Commissioner of Welfare	.6	.9	1.3	1.6
17. Office of Secretary, Department of Health, Educa- Welfare	2.7	3.8	4.4	5.7
Subtotal, items 1 to 17	[2] 3,084.3	3,834.6	[2] 5,405.0	6,016.6
B. Total program costs, loan programs:				
18. Rural housing direct loans	183.2	153.2	87.0	43.8
19. Public Housing Administration	566.6	790.1	872.3	1,077.5
20. Economic Opportunity loan fund		17.3	33.3	35.6
21. Housing for elderly or handicapped	19.1	43.6	58.0	72.2
Subtotal, items 18 to 21	768.9	1,004.2	[2] 1,050.5	[2] 1,229.2
Total, welfare programs	3,853.2	4,838.8	[2] 6,455.6	7,245.8

[1] Less than $60,000.
[2] Total does not coincide with sum of individual items due to rounding.

TABLE II.—*Education programs*

[Millions of dollars]

	Actual		Estimated	
	1963	1965	1966	1967
A. Total program costs, nonloan programs:				
1. Vocational education	34.7	171.3	261.5	250.8
2. Elementary and Secondary School Act of 1965			1,151.0	1,342.4
3. Higher Education Act of 1965		54.9	210.0	432.3
4. Higher education facilities construction		286.7	528.3	522.7
5. Grants for public libraries	7.4	54.9	55.0	57.5
6. National defense education	113.9	171.0	227.5	234.6
7. Educational improvement for handicapped	2.5	16.5	25.5	32.6
8. Research and training (cooperative research)	5.2	13.2	63.4	77.2
9. Foreign language training and area studies		1.5	2.0	3.5
10. Civil rights educational activities		4.4	10.0	9.1
11. Educational television	(1)	5.3	15.5	6.8
12. Salaries and expenses, U.S. Office of Education	12.2	18.4	29.5	41.6
Subtotal, items 1 to 12	175.9	[2] 798.2	2,579.2	3,011.0
B. Total program costs, loan programs:				
13. Vocational education				1.8
14. Higher Education Act of 1965			9.5	43.0
15. Higher education facilities		1.7	60.0	235.0
16. NDEA loans to students and nonprofit schools	87.3	122.7	183.1	1.5
17. Student loan insurance fund			(1)	0.3
18. College housing	339.1	312.8	336.1	399.8
Subtotal, items 13 to 18	[2] 426.5	437.2	588.7	681.4
Total, education programs	[2] 602.3	1,235.4	3,167.9	3,692.7

[1] Less than $60,000.
[2] Total does not coincide with sum of individual items due to rounding.

TABLE III.—*Health programs*

[Millions of dollars]

	Actual		Estimated	
	1963	1965	1966	1967
A. Total program costs, nonloan programs:				
1. Community health	339.2	471.2	684.6	769.4
2. Environmental health	39.6	62.5	83.2	108.6
3. Federal Water Pollution Control Administration	116.6	123.8	191.5	224.2
4. Regional medical program			25.0	45.0
5. Construction community mental health center			85.0	50.0
6. Construction health research facilities		63.7	56.3	21.0
Subtotal, items 1 to 6	495.4	721.2	1,125.6	[1] 1,218.3
B. Total program costs, loan programs:				
7. Student loans, community health practice		25.4	33.6	
C. Total costs, proposed new programs:				
8. Health research and personnel				41.0
9. Clean rivers				74.1
Total, health programs	495.4	746.6	1,159.2	[1] 1,333.4

[1] Total does not coincide with sum of individual items, due to rounding.

TABLE IV.—*Community development and renewal*

[Millions of dollars]

	Actual		Estimated	
	1963	1965	1966	1957
A. Total program costs, nonloan programs:				
1. Urgan renewal grants	[1] 335.5	282.5	331.0	375.0
2. Urban studies of housing research	.2	.4	.7	.8
3. Study of housing and building codes, etc				2.9
4. Community development training programs				2.2
5. Urban planning grants	12.4	16.6	20.0	22.0
6. Basic water and sewer facilities grants			1.3	50.8
7. Grants, advance acquisition of land				.4
8. Open space and urban beautification grants	.3	6.2	18.0	30.0
9. Neighborhood facilities grants			1.2	12.5
10. Urban mass transportation fund	([1])	11.7	38.4	68.6
11. HUD-Office of Secretary, salaries and expenses	25.2	29.6	36.2	44.1
Subtotal, items 1 to 11	373.6	347.0	[2] 446.7	[2] 609.1
12. Rural water and waste disposal			20.0	26.0
13. Rural renewal		.9	2.1	1.2
14. Rural Community Development Service programs	[3] .1	.1	.7	3.5
Subtotal, items 12 to 14	.1	1.0	22.8	30.7
B. Total program costs, loan programs:				
15. Urban renewal loans	([1])	277.6	265.9	281.7
16. Public facility loans	36.4	56.4	36.6	43.0
17. Public works planning	12.5	13.9	17.1	20.1
18. Rehabilitation loans		.2	2.4	18.2
Subtotal, items 15 to 18	48.9	348.1	[2] 321.9	[2] 362.9
C. Total program cost, new program proposal:				
19. City demonstration grants				5.0
Total, community development and renewal	422.6	696.1	[2] 791.5	[2] 1,007.7

[1] Grants and loans not separated in 1963, nor were amounts for urban mass transportation demonstrations.
[2] Total does not coincide with sum of individual items due to rounding.
[3] Office of Rural Areas Development.

TABLE V.—*Area and regional economic development*

[Millions of dollars]

	Actual		Estimated	
	1963	1965	1966	1967
A. Total program costs, nonloan programs:				
1. Appalachia (total)		0.4	95.7	188.7
(a) Region conservation and mining programs		.2	15.8	21.9
(b) Grants for local development district		(1)	31.7	53.8
(c) Development highway system		(1)	47.1	111.9
(d) Appalachia regional commission		0.2	1.1	1.1
2. Economic Development Administration (total)			19.9	[2] 93.6
(a) Development facilities grants			7.0	67.5
(b) Technical and community assistance			12.9	22.8
(c) Economic development center				3.2
3. Area Redevelopment Administration operations and grants	45.2	20.8	10.6	6.4
4. Public works acceleration	154.8	208.6	81.9	
5. Regional economic planning			2.0	5.5
6. Transportation research, including high-speed ground transportation		1.3	7.0	27.5
7. Highway beautification			70.8	91.8
Subtotal, items 1 to 7	[2] 200.1	231.1	[2] 288.0	[2] 413.4
B. Total program costs, loan programs:				
8. Economic development center loans				.8
9. Economic development loans		59.8	63.2	71.8
10. Small Business Administration loans under OEO		1.0	16.1	44.7
11. ARA fund	25.4			
12. Appalachia timber development loans			[3] .7	[3] .8
Subtotal, items 8 to 12	25.4	[2] 60.7	80.0	[2] 118.2
Total, area and regional economic development	225.5	[2] 291.9	368.0	468.6

[1] Less than $60,000.
[2] Total does not coincide with sum of individual items due to rounding.
[3] Primarily loans; approximately $100,000,000 a year in assistance.

TABLE VI.—*Manpower training and employment opportunities*

[Millions of dollars]

	1963	1965	1966	1967
A. Total program cost—nonloan programs:				
1. Office of Manpower Administration, salaries and expenses	0.8	7.1	35.4	39.2
2. Manpower development and training activities	51.9	208.9	401.0	400.0
3. Area redevelopment training activities	8.3	6.4	1.8	
Subtotal, items 1–3	61.0	[1] 294.3	438.2	439.2
4. Vocational Rehabilitation Administration, salaries and expenses	2.4	3.1	4.1	5.4
5. VRA grants and research	97.6	140.3	225.0	320.2
Subtotal, items 4–5	100.0	143.4	[1] 229.0	325.6
6. Equal Employment Opportunities Commission		.1	3.8	5.9
Total, manpower training and employment opportunities	[1] 160.9	[1] 437.7	671.0	770.7

[1] Total does not coincide with sum of individual items due to rounding.

TABLE VII.—*Advancement of science and the arts*

[Millions of dollars]

	Actual		Estimated	
	1963	1965	1966	1967
A. Total program costs—Nonloan programs:				
1. National Science Foundation	320.8	416.0	488.2	525.3
2. National Foundation on the Arts & Humanities and National Council on the Arts		(1)	7.8	17.9
Total, advancement of science and the arts	302.8	416.0	496.0	543.2

[1] Less than $60,000.

AFTERNOON SESSION

Representative GRIFFITHS. I would like to thank you very much, Mr. Goldfinger, for being here. We would be very pleased to hear what you have to say.

STATEMENT OF NATHANIEL GOLDFINGER, DIRECTOR, DEPARTMENT OF RESEARCH, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

Mr. GOLDFINGER. Thank you, Mrs. Griffiths.

At the outset, I would like to congratulate the Joint Economic Committee and this subcommittee for holding these hearings on the important current issue of tax changes for economic stabilization.

As I see it, the subject of these hearings cannot be discussed properly in a vacuum. Therefore, I shall attempt to deal with it, within the context of the current economic situation.

I believe that current economic developments and trends require elimination of the 7 percent tax credit for business investment in new equipment or an increase in corporate taxes, through an excess profits tax or an increase in the corporate tax rate—to curb the very sharp rise of business investment in new plant and equipment.

If such action is not taken in the coming weeks, the need to restrain the clearly out-of-line and unsustainable rise of business outlays for new plants and machines may become more urgent.

There are uncertainties about the economic picture. For example, it may become necessary to provide a further boost to military spending. Or the demand for goods and services may be expanding at a considerably faster pace than was expected at the beginning of the year.

Under such conditions, a prompt increase of corporate taxes would be needed to dampen down the pressures from the one-sector capital goods boom that arises largely from skyrocketing profits—through a combination of measures, involving elimination of the 7 percent tax credit for business investment in new equipment and/or an excess profits tax, and/or an increase in the corporate tax rate.

Standby legislation along these lines or some other appropriate method to assure prompt action should be available to handle this contingency.

The wisest course, in my opinion, would be elimination of the 7 percent tax credit now. If there was ever any justification for this Government subsidy of business investment in 1962, to stimulate outlays for new business equipment when such outlays were low in the early 1960's, then there is a powerful argument for elimination of this subsidy at present.

We are in the third year of an unsustainable capital goods boom and the Government's most recent reports indicate an even sharper rise of business outlays for the new plant and equipment in 1966 than was anticipated at the beginning of the year. Moreover, out of line capital goods boom is picking up steam, in an economy which already has the economic stimulus of the Vietnam conflict.

Although there are no general inflationary pressures in the economy at present, there apparently are some moderate, localized pressures in capital goods industries, in a few parts of the country. To the extent that there are any inflationary demand pressures at all, they come from sharply rising business outlays for new plant and equipment. And if these pressures are to be curbed, then, let us get at the source of the problem and curb this one-sector boom.

Moreover, the alternative suggestion of some people, to curtail Government investments in human resources and needed public services, would be grossly unfair and, perhaps, socially dangerous. It would be most unfair to compel the poor and the disadvantaged to bear the major burden of the Vietnam conflict and the capital goods boom. In addition, it would be socially dangerous, in my opinion, to undermine or destroy the popular expectations, aroused by the progressive social and economic legislation of the past several years.

Fiscal policy action to curtail the one-sector boom would prod business managements into reviewing and postponing some of their current plans to expand and modernize productive capacity. It could reduce pressures on resources in heavy goods industries, at a time when rising military spending is increasing demand in those same industries. It could bring the rise of capital goods outlays down toward a more sustainable rate and curb the potential of a sharp drop in such outlays a year or two from now. And it could leave ample economic resources for a continuing expansion of Government investment in human resources and essential public services—such as Federal programs of aid to education, retraining of the labor force, the rebuilding of our metropolitan areas and the war on poverty.

The tightened monetary policy of recent months, with interest rates at their highest levels in a generation or more, has not curbed the capital goods boom, since most large- and middle-sized companies have ample and sometimes huge supplies of their own funds, after 4 years of skyrocketing profits and internal flows of cash. In addition, such companies can borrow money under the most favorable circumstances and at the prime rate. But the tightened monetary policy has possibly curbed residential construction, which has been a relatively weak area of the economy for several years. It undoubtedly is curtailing State and local government outlays for the expansion of needed public services. And it is clearly increasing the cost of loans to consumers and small business. Further tightening of monetary policy can possibly generate a downward spiral through most parts of the economy, perhaps bringing an end to the capital goods boom, but only after other sectors of the economy have been pulled down.

The sharply out-of-line capital goods boom, which has been fostered by Government subsidies and tax reductions on business income, can and should be curbed by an effective rise of business taxes.

The one-sector boom of corporate profits and business investment in new plant and equipment should not be confused with a general economic inflationary situation.

There are no general, widespread inflationary shortages of goods, productive capacity, and manpower. There is no generally excessive demand for goods in short supply. There is no consumer scare buying or hoarding. Neither is there evidence of a widespread, sharp buildup of business inventories.

In addition, the increase of social security taxes on employees effective January 1, 1966, is cutting into consumer income by over $2½ billion this year. And the recent tax measure, adopted by the Congress, will have the effect of withdrawing about another $1 billion, or close to it, from consumer buying power in 1966. Fiscal policy restraint of consumer buying power is already in effect, although there is no sharp rise of consumer spending and there are no inflationary shortages of consumer goods.

Moreover, the economy is not yet at full employment or at the ceiling of its vast productive ability. In most industries, and in almost all parts of the country, there are still considerable numbers of unemployed and underemployed people and amounts of productive capacity.

The economy's ability to produce more goods and services, more efficiently, is expanding rapidly. The labor force is expected to grow about 1½ million, or about 2 percent, this year.

Productivity, which has been rising at a rapid pace in recent years, is expected to increase about 3 percent in 1966. Moreover, it is anticipated that installations of new plants and machines will expand industry's productive capacity by approximately 7 percent or more.

The American economy has the resources for a considerable rise in demand this year without general and widespread inflationary shortages. Moreover, it is important to remember the difference between the economic impacts of the current situation and the Korean conflict, when inflationary pressures required a wide range of restraints, regulations, and controls.

Our economy is now about twice as big as it was in the early 1950's. In 1952 and 1953 national defense expenditures accounted for about 13 percent of total national production. In contrast, defense expenditures accounted for 7½ percent of total output in 1965, and in 1966 they are expected to account for an only slightly greater share. In addition, the Korean war required a sharp rise in the size of the Armed Forces and in military expenditures. The Armed Forces are expected to expand 300,000 in 1966—they rose 1½ million between 1950 and 1951. Moreover, in contrast to the scheduled increase of military spending this year, defense expenditures rose $19.5 billion between 1950 and 1951 and another $12.3 billion in the following year.

In light of this analysis of the current economic situation, I view with suspicion the proposals of those who say we are in the midst of a general, widespread inflationary situation that requires slamming on the brakes. Such action could halt or reverse the welcome reduction of unemployment at the very time when the economy is at long last beginning to provide job opportunities for the poor; the disadvantaged; and the unskilled, long-term unemployed. Moreover, cutbacks of such Government programs as the war on poverty, aid to education, manpower retraining, and the rebuilding of our metropolitan areas—as proposed by some people who desire to slam the brakes on the economy—could undermine or destroy the hopes that these programs have aroused among the poor and most of the population.

However, we are in the midst of a one-sector boom that is creating distortions and some localized strains in the economy.

From 1963 to 1964, outlays for plants and machines rose 11.4 percent—two-thirds faster than the increase of total national production. And from 1964 to 1965, such outlays soared 15.4 percent—slightly more than twice as fast as the gross national product. This year, expenditures for plant and equipment are expected to soar again by about 16 percent, or about twice as fast as total output.

This trend is clearly unsustainable. Business outlays for plants and machines cannot continue to rise twice as fast as total demand for too long. Such out-of-line, one-sector boom results in the addition of large amounts of new productive capacity, at a much faster pace than the demand for goods and services. When idle capacity begins to increase, as in 1957—during the one-sector capital goods boom of 1955–57—businessmen begin to cut back the outlays as they did rather drastically in 1958.

Moreover, there is some evidence that the American economy cannot long sustain rising economic activities and low levels of unemployment when outlays for new plant and equipment account for over 10 percent of total national production. At the 1963 meetings of the American Statistical Association, Prof. Arthur Okun, of Yale University, a present member of the Council of Economic Advisers, concluded a careful examination of this issue with the following observation:

> Over the long run, we may optimistically hope to do better than the implied 9.8 percent as our investment ratio at full employment. But, at this point, such a view is better supported by hope than by conviction.

However, outlays for plants and machines accounted for 10.3 percent of total national production in 1965 and they were rising rapidly. This year they are now expected to move up to about 11 percent of the gross national product—perhaps $7 to $8 billion above a sustainable level.

In 1958 business investment dropped sharply after accounting for 10.5 percent of total national production in the previous year. I think it is utterly clear by any rational method of examination that the current one-sector capital goods boom cannot be sustained.

But the difficulty with this out-of-line movement of business investment does not only lie in the future: it is generating difficulties at present.

With military expenditures now rising, in response to the Vietnam situation, the only sector of the private economy that is increasing very sharply is business outlays for new plants and machines. This one-sector boom is creating some localized strains within heavy goods industries in some parts of the country. And, in combination with rising military expenditures, it is generating boom expectations among some businessmen—a psychological environment for them to boost prices even in industries whose production is not rising sharply and with little regard to cost.

In 1955–57, a one-sector capital goods boom, without rising military expenditures, generated short-term, temporary strains in a few capital goods-producing industries and a price-boosting psychology that spread through the economy. And now, in 1966, we seem to be in a somewhat similar situation.

Although unit labor costs in manufacturing industries continued their declining trend from last year—and industrial unit labor costs appear to be relatively stable thus far in 1966—the level of industrial prices has been moving up slowly. The gap between wholesale industrial prices and industrial unit labor costs has not been so great since the early 1950's.

The way to curb this trend in the economy is to curb the out-of-line, one-sector capital goods boom. And the way to do so, in my opinion, is to eliminate the Government's subsidy of business investment, and/or to increase taxes on corporate profits.

The capital goods boom has been encouraged and fed by Government policy. Since 1962, taxes have been cut and the net reduction will amount to an estimated $21.7 billion in 1966. Of these net reductions, more than half is going to corporations and to the top-income 15 percent of American taxpayers.

The 7-percent tax credit and the reduction of corporate taxes from 52 to 48 percent have boosted after-tax profits. And the rise of sales, accompanied by rapidly increasing productivity, relatively stable labor costs in the economy as a whole, and declining unit labor costs in manufacturing, combined with an upcreep of prices, have contributed to the profits boom.

From 1960 to 1965, profits rose 50 percent before taxes and 66 percent after taxes, approximately twice as fast as the 27-percent increase in total wage and salary payments and much faster than the 33-percent rise in personal income. In 1965, alone, profits rose 15 percent before taxes and 20 percent after taxes, more than twice as fast as the 7-percent increase of total wage and salary payments and the similar rise of after-tax personal income.

Depreciation allowances have also been rising rapidly, as a result of the step-up of depreciation, under the Treasury Department's change of rules in 1962, as well as the expansion of plant and equipment. The cash flow to corporations (after tax corporate profits plus depreciation allowances) has been moving up more sharply than total wage and salary payments and after-tax personal income. From 1960 to 1965, the cash flow to corporations rose 56 percent and in 1965, alone, it increased 13 percent.

Moreover, the flow of cash to corporations is accounting for an increasing share of the corporate gross product. It accounted for 18.4 percent of the gross product of nonfinancial corporations in 1964, and 19.1 percent in 1965—compared with 18.2 percent in 1955 and 17.6 percent in 1956, during the capital goods boom of the mid-1950's.

These lopsided flows of income have fed the one-sector boom of business outlays for new plant and equipment that is distorting the economy. This distortion, which threatens some price pressure now, and an economic decline in the future, should be curbed by rescinding the 7-percent tax credit and/or increasing corporate tax rates.

If there are inflationary pressures anywhere in the private economy at present, they are to be found in the one-sector boom of profits and capital goods outlays. Any rational effort to curb these pressures would require a curb on this one-sector boom.

Postponement of some current business plans to expand plants and machines would reduce local strains on the economy—when military spending is rising and a further boost is possible—and curb the boom psychology that threatens general increases in the price level. Such postponement would bring down business investment toward a more sustainable level. And it would leave room for the expansion of essential Government programs.

To accomplish its task of fostering balanced economic growth to reach and sustain full employment, a flexible fiscal policy is certainly needed. But fiscal policy, at any point in time, must be aimed at the special problems that exist, rather than using a general blunderbuss approach. At present, for example, restraint of the one-sector capital goods boom is required, rather than tough general restraints on both consumer and business income.

Moreover, the discussion of fiscal policy in recent years has overemphasized the tax side and underemphasized Government investment. The long-run growth of the economy and the strengthening of American society require increasing Government investments in human resources and in the expansion and improvement of public services. If such investments were increased on a long-term basis, with 10- or 20-year targets to meet public needs, the rate of expansion could be speeded up or slowed down, depending upon changes in defense requirements and the availability of manpower and productive capacity.

In any case, when the present rise of military spending levels off or declines, the Government should promptly increase its investment in the improvement of public services and in human resources, to sustain the economy's advance. Just as the Government should be prepared for the contingency of a further rise of military spending, it should also be prepared to offset the easing of military expenditures.

The Federal Government should develop, coordinate, and maintain a national inventory of needs for housing, community facilities, and public services, based on present backlogs and future population growth. Each State and metropolitan area should be encouraged to develop an inventory of needs within its geographical jurisdiction, in addition to the development of a coordinated national inventory, prepared by the Federal Government.

Such comprehensive inventory of needs should provide the foundation for nationwide programs in each category—based on Federal financial and technical assistance to the State and local governments, including Federal grants-in-aid and guaranteed loans, as well as direct Federal efforts. Target dates should be established for achieving specified objectives and the pace should be speeded up or slowed down, depending upon the availabiltiy of manpower and productive capacity and changes in economic conditions.

Such planned effort in the area of Government investment would reduce pressures on Federal tax policy while at the same time it would make our Federal fiscal policy more equitable and flexible. And it would add strength to the national economy and to the fabric of our society.

Representative GRIFFITHS. Thank you very much.

I particularly want to thank you on behalf of the full Joint Economic Committee for your suggestion on the investment tax credit, because most of the committee happens to agree with that.

Mr. GOLDFINGER. I was very glad to see the committee report, Mrs. Griffiths.

Representative GRIFFITHS. I would like to ask you this, though. What emphasis do you place upon the fact that it would operate too slowly?

Mr. GOLDFINGER. Well, that remains to be seen. This is a matter of judgment. I don't believe that it would operate too slowly.

The big issue, I think, is to try to get business managements to review their plans and I think that dropping the 7-percent credit would get such review, and would get some postponements. If that is not enough, then perhaps some additional measures would be needed.

I would suggest that dropping the 7-percent credit now, I think, as I said in the statement, would be the wisest course.

Representative GRIFFITHS. I was interested in noticing your review of the taxes that had been levied or expended and on which the economy has not yet felt the whole impact. You did not mention the increased collections——

Mr. GOLDFINGER. On the corporate side.

Representative GRIFFITHS. Yes, but on the personal side, too.

Is it not your opinion that this is going to dampen off demand?

Mr. GOLDFINGER. Well, I think on the consumer side that it will. I have some doubts about much effect on the corporate side, because corporations set aside the money for taxes, unlike most individuals. On the individual side, the speed-up in terms of graduated withholding does have an impact, and probably a fairly substantial impact in terms of the degree of speed-up, whereas on the corporate side, because of the way corporations operate, on a planned basis, unlike individuals, I don't think that there will be much restraint on what corporations plans in terms of outlays. There may be, as a result of this action on the corporate side, some dampening in the monetary field, in the money markets, because this probably would mean the withdrawal of corporate funds from short-term paper.

Representative GRIFFITHS. Since you have pointed out that all capital goods booms have ended—if we do nothing, in your opinion, when will this one end?

Mr. GOLDFINGER. Well, you mean when will this capital goods boom end?

Representative GRIFFITHS. That's right. Do you think that——

Mr. GOLDFINGER. That is crystal-ball gazing.

Representative GRIFFITHS. That's right. As our repealing the tax is really crystal-ball gazing, too.

Mr. GOLDFINGER. Well, I think it is much less crystal-ball gazing to repeal the tax, because with certainty, I would say, there would be some impact. It is a debatable point as to how much impact. But I think it is safe to say that there certainly would be a very definite impact from dropping the 7-percent credit.

Now, in terms of the capital goods boom, if this thing continues without dropping the 7-percent credit or an increase in corporate taxes, I am afraid that the capital goods boom will end just about the time when military spending levels off or declines, and we will get a combined impact of both of those things. That could be at some point next year or maybe even earlier, depending on the trend in military expenditures. I mean that would be my offhand rough guess. I can spell that out a little further, as to why I guess this.

Representative GRIFFITHS. All right.

Mr. GOLDFINGER. We are building up a good deal of plant and productive capacity now, and this will be going on during the course of 1966. The expectations are for an increase in industrial capacity of about 7 percent or more.

Well, even with the current kinds of increases that are expected in output, it is not likely that we will be pressing on capacity in the aggregate sense, any more than we are today.

In other words, the amount of idle capacity at the end of the year probably will be at about the same level as it is now.

However, at the point when military spending begins to level off or decline, we will begin to build up idle productive capacity. We may begin to build up idle productive capacity even before that takes place, if consumer spending, which has not been rising very sharply recently—in fact, retail sales have remained relatively the same for the past 4 months, from November through February——

Representative GRIFFITHS. Car sales are down, are they not?

Mr. GOLDFINGER. Slightly, yes.

Representative GRIFFITHS. Very slightly.

Mr. GOLDFINGER. But overall retail sales have remained about the same, ever since November, with some slight fluctuations.

The end of the capital goods boom, therefore, could occur even before a leveling off of military spending.

Representative GRIFFITHS. Under those circumstances, and since, in my judgment, one of the things that has created the problem now, has been the fact that we have added one tax reduction on another without waiting to see what the effect was—we had depreciation guidelines, investment tax credit, income tax reduction, excise tax, and so on, one after another, and now we are getting the accumulated effect of all the tax reductions.

In spite of the fact that many people now urge that something should be done at once, and many of the witnesses before this committee have urged that something be done at once to stop inflation now, don't you think that there is a possibility that action now could be too soon?

Mr. GOLDFINGER. Well, that's perfectly possible in terms of the action that has been proposed by some of the people who have appeared before this committee. I say this on the basis of newspaper reports—because some of the people, or maybe many of the people who have appeared before this committee during this week or more of hearings, have suggested that we are in the midst of a general inflationary pressure and have suggested that, in terms of this economy-wide situation of inflationary shortages and inflationary pressures that we have to slam on the brakes, or put on some kind of tough curbs on both consumer income and on business income—and I think their analysis is all wet and I think their suggestion is all wet.

I do not think that we have a general economy-wide inflationary situation. We have no consumer scare buying, we have no consumer shortages. I am quite sure that you would have to hunt to find any examples of shortages in the economy at present.

On the other hand, what we do have is a capital goods boom, a one-sector boom, which is way out of line with the rest of the economy and has been way out of line for 2 years now, and we are now in the third year of this thing, in an economy which is complicated by rising military expenditures in response to the Vietnam situation.

Now, as I think about this, Mrs. Griffiths, I think back to the one-sector investment boom of 1955–57, and I look back to that excellent study which was published by the Joint Economic Committee and prepared by Charles Schultze, who is now the Budget Director, who examined in careful detail the 1955–57 situation, and I think what you will find in Schultze's paper in some ways is unfortunately somewhat similar to the current situation—not a general inflationary condition, but a one-sector boom with all kinds of side impacts, and a boom psychology which threatens general economy-wide price pressures. This is the thing I fear. And I think that in terms of the current situation, in terms of the distortion and the price pressures that may well emanate and are beginning to emanate from the capital goods boom, I think it would be wise to drop the 7-percent credit now.

Also, I would ask you, and ask the committee, to keep in mind the unsustainability of this capital goods boom. I think that by dropping the 7-percent credit and/or increasing corporate taxes now to curb this boom at present, we not only would be dealing with the current situation—I think we would also be easing some of our future problems that may start a year from now more or less, in terms of the decline of capital goods spending.

Representative GRIFFITHS. Well, there are more taxes coming, just through the course of the thing, that have already been enacted. There are increased tax collections coming, but there are also additional employees coming. This is the end of March and in June, with college and high school graduations, there will be more young people entering the labor market than in any previous June in our history. So perhaps there is something to be said for the fact that it is too soon to put the brakes on generally in the economy.

Mr. GOLDFINGER. I agree with you on that, Mrs. Griffiths. I think it would be wrong to put on the general brakes on the economy as a whole at this point.

Representative GRIFFITHS. And one of the really delightful things about the 7-percent investment credit is that it could be so easily restored if it starts really to hurt. If it were repealed now, or suspended now, and it really begins to hurt the economy, then I presume it could be easily restored.

I would like now to ask you something about this sort of shelf of public works, a reviewing of our needs.

It has been quite interesting in this committee hearing at this time, that few people have come in who have dwelt heavily upon reducing expenditures. I think perhaps one of the reasons has been that they feel the cause is lost, that we never are going to decrease expenditures, and I think maybe that's correct—at any rate——

Mr. GOLDFINGER. I hope you are right, that their cause is lost.

Representative GRIFFITHS. I think that it has been discovered that this part of our fiscal policy is harder to turn off and on than taxes and we are having trouble enough turning off taxes.

But the part of reducing the expenditures or increasing them is pretty difficult.

I would say that that may remain so and it would be exceedingly difficult to bind a future government with any suggested programs that we might suggest or that the Executive might suggest now for future slowdowns in the economy.

Mr. GOLDFINGER. Well, I would like to comment on that and expand on those last few paragraphs of the paper I submitted.

Representative GRIFFITHS. All right.

Mr. GOLDFINGER. In the first place, as far as I know, we have never, in the United States, planned our Federal investments in the areas that I suggested. I think that it not only would be wise policy but I think it is necessary at this point to plan our expenditures in the areas of housing, community facilities, and public services generally, based upon the backlogs of present need and future population growth, and to set targets, such as 5-, 10-, and 20-year targets.

For example, I have done a good deal of checking, Mrs. Griffiths, and it is hard to find at this point general acceptance of what the current shortage of hospital beds is, and where they are, and what the shortage of housing is—although on housing we have much better information. But there are these areas. And we are flying blind. I don't think that we need to fly blind. We can get estimates. They may be somewhat off but it would be better than flying blind.

We could set up these plans and set up targets and we can review the plans and review the programs.

It is my opinion that once we have extensive planned programs based upon a national inventory of needs, which we do not have at present—and I would urge you to urge your colleagues to get underway such a national inventory of public needs—once we started to work on that kind of planning, with maybe annual reviews, I think it would be possible to speed them up, to slow them down, at least in some areas.

I think the trouble now is that we are not operating on a long-term basis; we are operating on a year-to-year basis and flying blind.

And what I suggest is that if we did this on the basis of a long-term plan, based on a national inventory of needs, we then would find it possible to slow them down or to speed them up depending upon national priorities.

We may decide that housing should have prior emphasis over some other activity. Maybe housing should not be slowed down. Maybe some kind of public building construction could be slowed down under some circumstances, and under other circumstances speeded up at a more rapid rate. But we would know where we are going.

Representative GRIFFITHS. Thank you.

Senator Proxmire has a different view on the investment credit.

Senator Proxmire?

Senator PROXMIRE. Yes, indeed.

I want to commend you, incidentally, on what I think is an excellent paper. You have a lot of very fine things in here with which I agree.

Mr. GOLDFINGER. Thank you, Senator.

Senator PROXMIRE. I think they are particularly well expressed. I am delighted to see your emphasis on what tightening of monetary policy has done or could do. We just had a story yesterday about the sharp drop in housing starts, which I think should be a real warning to us.

Then I am also happy to see—and you are the first witness, I think, who has given us this kind of comprehensive exposition of the actual price situation, and I think it has given us a very accurate picture of the fact that we are not now suffering from general inflation.

I think the arguments you have here are very helpful.

Incidentally, are you familiar with the recent memorandum by Gardiner Means? I put it in the record just yesterday.

Mr. GOLDFINGER. I am very glad you did. Dr. Means gave me a copy only a day or two ago. I just glanced at it. I have not read it in detail. He explained his thesis to me.

Senator PROXMIRE. In general, with some exceptions, he seems to agree with your notion. He calls the current price performance a reflation, but I think what he is talking about is a catching up of food prices—that is, the price the farmer gets, a catching up of prices in some of the mining industries, and so forth, for raw materials—catching up with the situation which had just gotten out of balance. For years, these prices were stable or dropping while other prices rose steadily year after year. In the last few months they have been catching up.

Mr. GOLDFINGER. If I may, sir, I would like to indicate one point where I believe that I disagree with Dr. Means, and that is on the impact of this one-sector boom. I do think that there is a distortion and some price pressures emanating from the one-sector boom, as distinct from economywide pressures.

I do think that there are some localized strains and some localized pressures, but in addition to that, this one-sector boom also creates a kind of general boom psychology, and I think these are the difficulties.

Senator PROXMIRE. Well, now, let's take a look at this so-called capital goods or one-sector boom.

You give us statistics on the sharp rise in investment in plant and equipment.

Mr. GOLDFINGER. Yes, sir.

Senator PROXMIRE. But you do not give us any other evidence that there is capital goods inflation. What capital goods prices are increasing? How much are they increasing?

Mr. GOLDFINGER. The pressures to date that I am aware of are in the industrial materials and machinery areas, and in those areas prices have begun to move up.

Senator PROXMIRE. Exactly. Now, in those areas you have an increase, a sharp increase, in the crudest kind of raw materials.

Mr. GOLDFINGER. Yes, sir.

Senator PROXMIRE. As I understand, an increase over 2 years of around 4½ percent, something like that. You have an increase of only

2 percent in the so-called intermediate materials, the way Means classifies them. And you have an increase of less than 1 percent in the industrial goods for the consumer.

Now, it would seem to me that this is hardly very clear evidence that the capital goods boom is so acute that it can be called a one-sector inflationary impact.

The biggest inflationary impact called to our attention by administration experts in the last couple of months is not in capital goods at all. It has been in food.

Mr. GOLDFINGER. Well, in terms of the price level, that is true. The sharpest price increases have been in the food area. Many of those prices are expected to come down in terms of the demand and supply situation, and the change in such situation later on in the year, or next year.

However, the difficulty that I would like to stress is that the one-sector capital goods boom is not only creating these price pressures in that sector—the price pressures in terms of raw materials, industrial machinery—but with the additional complication of the Vietnam situation, it is creating a general boom psychology which could well tip off price increases throughout the economy. This is the difficulty in terms of the current situation.

Senator PROXMIRE. Well, what it comes down to is just a psychological reaction that has no basis, apparently, in fact—a psychological feeling that because of the Vietnam impact, which you and I agree is not really significant as compared with any other conflict of this kind that we have had, because of the enormous size of our economy—and your statistics are excellent there in showing how much smaller the total military impact is on our economy now than it was in peacetime, so the Vietnam situation is not terribly significant.

This capital goods situation, we have no price evidence, no shortages that we can define or measure that would suggest that we are getting an inflationary situation in this particular area.

We have the further argument, made by those who disagree fundamentally with your viewpoint, that if we are going to meet inflationary pressures in the future, we have to expand our plant and equipment now. In other words, if we are going to be in a position where we are going to maintain price stability from now on, it would be mistake to retard investment in plant and equipment.

Mr. GOLDFINGER. Well, let's examine that last issue.

I think that the people who say that are dead wrong.

I would say, sir, that the suggestion I am making would, over the long run, result in more capital goods and more productive capacity than to permit this one-sector capital goods boom to run on to its normal end.

We saw what happened as a result of the 1955–57 one-sector capitol goods boom, when capital goods expenditures declined drastically in 1958 and remained relatively stagnant until about 1961–62.

What I am suggesting is not that we kill off capital investment at all. What I am suggesting is the importance of trying to keep capital investment on a more or less sustainable basis, on a more or less sustainable level.

I believe, sir, and I believe strongly, that the unsustainability of this capital goods boom, the very existence of this one-sector boom in its extreme form at present, is in good part the result of Federal Government actions, of administration policies—the combination of the 7-percent credit in 1962, the change in Bulletin F in 1962, and in addition to all of that, the 4-point reduction in the corporate tax rate.

It was the deliberate planned effort of the administration to boost capital expenditures, and to increase the share of capital expenditures as a percent of GNP.

We now have the results of what they did.

I believe, frankly, that it is the responsibility of the economists who made these proposals and suggestions to now come down and clearly show that this thing has run beyond their expectations and that there is a need to call it off and curb it because of its unsustainability in terms of the future; but also in terms, I believe, of the present mild inflationary pressures that seem to be generating. And once again, I want to call your attention to the inflationary pressures that did emanate out of the 1955–57 situation, which in many ways was roughly similar; a one-sector capital goods boom, when the rest of the economy was not booming.

Senator PROXMIRE. Now suppose in 1955–57 we had investment credit.

Mr. GOLDFINGER. We had something similar to that, because the Eisenhower administration put forth the 1954 thing.

Senator PROXMIRE. Supposing in 1957, on the basis of this kind of advice, that Congress had repealed that investment credit. We know what happened in 1958–59 as it was, to investment in plant and equipment. Just imagine what a tremendous recession we would have provoked by this drastic change in what has now become a very, very important element of investment in plant and equipment.

In other words, we cannot see, it seems to me, much more than a few months ahead in any kind of reliable economic prediction.

The Treasury has told us an economist who appeared before us had confirmed this—there is a lag of 9 months to a year or more in the impact of suspending the investment credit. Now, if you suspended the investment credit, say, in June of this year, and you have a recession in mid-1967 then our action in suspending the investment credit would have no effect in stemming current inflationary forces, but a serious adverse effect on the 1967 recession.

Mr. GOLDFINGER. Well, in the first place, sir, I think that dropping the 7-percent credit now would have an early impact in terms of getting business management to recview and postpone some of their plans for expansion.

Furthermore, of the various tax reductions——

Senator PROXMIRE. When would that have an impact?

Mr. GOLDFINGER. I think it would have a quick impact, within the course of weeks—a couple of months.

Senator PROXMIRE. You think the Treasury is wrong in this respect?

Mr. GOLDFINGER. Yes, I do. I think this is a matter of judgment.

I have a strong conviction that there would be an early impact. I don't know how strong it would be.

Senator PROXMIRE. They were showing—they analyzed very carefully, it was not a guess on their part—the length of time between placing an order and delivery and getting the manufacturing going on the new machinery, and getting the construction on the way and so forth. They analyzed for a number of industries and for industry as a whole. They did not go into construction very deeply, they said that would be even longer in lag.

Mr. GOLDFINGER. But some of the backlogs would be cut down. Some of the backlogs of the producers would be cut down. Some of the expectations would be cut down. Some of the steam would be let out.

Representative GRIFFITHS. Some of the orders would be canceled.

Mr. GOLDFINGER. Sure.

Representative GRIFFITHS. That's the way it would be done, as opposed to applying the investment credit to the order, not when the machine is in place. If you applied it to the order, it's true they would not cut it out, once ordered. This would appear only prospectively. But since it is when the machine is in place, then you would, or could sustain an argument that some of these people would start canceling the orders.

Mr. GOLDFINGER. I believe they would.

Senator PROXMIRE. If I may interject at that point, I certainly agree wholeheartedly on a one-shot basis that would have that effect. But think what happens in the future. What businessman is going to rely on an investment credit and place his order, get all set to buy his equipment, and then the Federal Government may come along any time it wishes, and cancel the value of that for tax purposes. It seems to me you introduce an element of uncertainty into investment which would be very bad.

Mr. GOLDFINGER. I don't find that very persuasive, Senator Proxmire. All of us operate and live under those conditions of uncertainty.

Senator PROXMIRE. You are introducing a new element of uncertainty, however.

Mr. GOLDFINGER. But what's the difference between the individual's operation under uncertainty when taxes change, or when monetary policies change, after one buys a house?

My colleague, with whom I rode over here, told me about his ordering a house which is now under construction and the change in monetary policy in the interim has increased the cost of the mortgage and has also made it difficult to get a mortgage. What's the difference between uncertainty on the individual side and the corporation on the corporate side? I fail to see the persuasiveness of this thing.

Furthermore, in terms of the impact on investment, I am not suggesting that the 7-percent credit should be placed on a countercyclical basis. I want to emphasize here that we of the AFL–CIO opposed the investment credit all the way along the line. We said that it was an unneeded device——

Senator PROXMIRE. So did I, incidentally, but I was wrong.

Mr. GOLDFINGER. I don't think you were wrong, Senator Proxmire.

If you view the effects, the shortrun effects as good, that is the sharp rise of business investment as good, I think you also have to take into consideration the unsustainability of this one-sector boom and the longer run impact. And the overall longrun impact, I say, is a bad one.

I think that over the long run, you get much more plant capacity, much more productive capacity, by operating on more or less of a sustainable basis, without artificial Government subsidies.

Why should the Government subsidize business investment?

Senator PROXMIRE. Well, let me ask this: Were you here this morning when Mr. Davidson testified?

Mr. GOLDFINGER. No, I was not.

Senator PROXMIRE. He gave us some very interesting material which indicated that—incidentally, it clashes with at least one of your figures. Where you say outlays for new plant and machines accounted for 10.3 percent of total national production in 1955, rising rapidly, he shows 7.7 percent. I tried to check this out with the staff and they say his figure of 51.8 is correct for plant and equipment. GNP, 675.6 is correct. So it would seem his 7.7 point figure is right.

Now, his 8.4 percent, which is the figure that he said we now have in 1966—that is a Government estimate—that this figure, while high, is no higher than it has been before in 1956 and 1957, not as high as it was in 1948, and furthermore, the significant fact is that you had before that 1956–57 period a long period of time when the investment in plant and equipment was around 7½ to 8 percent—in that general area of GNP.

We now have a period in which in 1961 it was 6.6 percent, 1962, 6.6 percent; 1963, 6.7 percent.

What I am trying to say is, we have some catching up to do.

No. 2, it seems to me as we speed up the process of automation, which Mr. Reuther and others are enthusiastic about, and I certainly am—I think this is the only way we can really advance our productivity and our standard of living—I would hope that we can get perhaps a higher investment than 8 percent or 8½ percent or maybe even 9 percent.

Mr. GOLDFINGER. Well, I don't think that is sustainable at all.

But before we get into the argument, let me suggest that you check with the staff again. I hold that my figures are right, and I can explain them to you.

If you are comparing business investment as a share of GNP, the figure to use, to be consistent, is nonresidential fixed investment, which last year was $69.8 billion, out of a GNP of something like $676 billion.

Senator PROXMIRE. Well, as I understand the basic difference is that your figure includes construction. Our figure here is a comprehensive figure including everything which is subject to the investment credit. This is what we are talking about.

Mr. GOLDFINGER. But the investment credit also has a side impact on plant investment as well, and I was looking at the overall issue of investment outlays. This is where the boom exists.

But anyway you look at it, Senator, if you take that gentleman's figures or the figures I submitted, I am sure that you would find the same thing, and that is an extremely sharp rise of business investment outlays. That is one thing.

The other thing is that I insist—it is my utter conviction—that the present level of business investment outlays is not sustainable. I would suggest that if you look back over time, you would find that when business investment as a share of GNP reached the current level or anything close to the current level, we began to move into trouble. I am suggesting that we will be moving into trouble, as a result of this capital goods boom.

Senator PROXMIRE. You seem to be implying constantly that you have to—somehow the Government has to zero in on an average rate, or a sustainable rate, as you put it, of business investment in plant and equipment, and extract that, or extort or insist on it from industry.

Mr. GOLDFINGER. No.

Senator PROXMIRE. And it seems to me we are always going to have some fluctuations. There may be compensating action which the Government can engage in, and which you very properly and logically argue here. But it seems to me that we have to expect there to be a fluctuation of a kind and that it would be a mistake for the Government to contribute to that fluctuation by creating an uncertainty as far as the investment credit is concerned, and relying much too heavily on economic forecasting, which is so unsure, to assume that when it gets up to the present level that is too high and, therefore, we cut out the investment credit, and by the time we get around to restoring it, if we do restore it, and I am not sure you want to do that—if we do restore it, then you have a recession on your hands.

Mr. GOLDFINGER. But if you think back to 1961, you will probably remember much better than I do, how the administration argued strongly all the way from Secretary Dillon and Walter Heller on down, on the need for a Government subsidy for business investment, to spur a rise in business investment, and also to increase the share of GNP going to business investment.

I recall rather vividly the paper that was submitted in March of 1961 as the first report of the Council of Economic Advisers under President Kennedy—the paper that was submitted to this committee, the Joint Economic Committee—in which it was fairly clearly stated that the drive was to increase the investment share of GNP.

Now, they did that. And we do have an increased share of GNP going to investment. And I think it has reached the points of unsustainability, as well as high pressures.

I give you as one of the examples, the study made by Arthur Okun, who is new a member of the Council.

Senator PROXMIRE. You don't mean it's not going to fluctuate up and down?

Mr. GOLDFINGER. I mean this thing probably will collapse. Mild fluctuations are to be expected. But sharp fluctuations are dangerous. We got a very sharp rise. I think that after this kind of sharp rise we are going to get a sharp decline, and I think that would be too bad.

Senator PROXMIRE. Supposing the GNP somehow can continue to grow at a fairly regular pace. Supposing it goes up $40 billion from year to year. There is no reason we could not sustain $60 billion of plant and equipment, and have it gradually rise after a while.

Mr. GOLDFINGER. Of course.

Senator PROXMIRE. It would be a smaller portion of the GNP, but it would not collapse, it would not go down to $35 or $40 billion again.

Mr. GOLDFINGER. No. All I am saying, sir—and I have an estimate here—all I am saying is that on the basis of past performance, as I said in my paper, there is some evidence that the American economy cannot long sustain rising economic activities and low levels of unemployment when outlays for plant and equipment account for over 10 percent of GNP.

I think this is an issue which has been examined, and there is some evidence to support it.

This is my personal view.

Senator PROXMIRE. I think that's right. I think what Okun is saying is it is probably not going to be that high, it's going to fluctuate, it's going to go down as a percentage. But I just don't understand why we should adopt a tax policy to try to eliminate all fluctuations in plant and equipment especially—and you and I agree we don't have general inflation—you cannot cite any instances or figures to show that there have been price rises in capital equipment, in this area, which would indicate a specific so-called one sector inflation. I haven't heard any. And under these circumstances, it is very unpersuasive to contend that we should suspend this tax, which is going to create uncertainty, and might very well provoke a deep drop in business activity in 1967.

Mr. GOLDFINGER. Well, Congress in part created this uncertainty by adopting the 7-percent credit.

Senator PROXMIRE. If we do it as a temporary device for cyclical purposes, I think it would. But I don't think we did.

Mr. GOLDFINGER. Congress adopted this, and put this subsidy into effect, and it is a subsidy.

Senator PROXMIRE. How can it be a subsidy if you say you are going to reduce somebody's taxes—it is certainly a play on words, a semantic trick, if you say this is a subsidy.

Mr. GOLDFINGER. No, sir. I firmly believe it is a subsidy.

Senator PROXMIRE. It's available to everybody.

Mr. GOLDFINGER. I'll show you how it is a subsidy.

You get a 7-percent after-tax credit for investment in new equipment. In terms of the corporate tax rate, this is roughly equal to 14 percent. On top of that, the corporation then depreciates 100 percent of the price of the product. The corporation therefore is getting 114 percent over the life of the equipment. I insist that the 14 percent, or the 7-percent after-tax credit, is a subsidy.

Senator PROXMIRE. Do you know of anybody who called the income tax cut in 1964 a subsidy to the taxpayer?

Mr. GOLDFINGER. No, it was not.

Senator PROXMIRE. What's the difference?

Mr. GOLDFINGER. Because the individual income tax payer is not getting the same thing that this 14 percent amounts to. The 14 percent on top of 100-percent depreciation, it seems to me, clearly adds up to a 14-percent subsidy.

Senator PROXMIRE. Let me shift to the last page of your statement, which I thought was very interesting, because it is a beautiful contrast with Mr. Davidson this morning.

Mr. Davidson suggested that we have regularly scheduled tax cuts, kind of on the shelf, and as I understand it, as we have a military situation or a situation that requires additional spending, that we postpone those tax cuts, but that they be scheduled on a long-term basis.

You, on the other hand, are suggesting precisely the opposite, that we have a long-term responsibility for meeting the needs of our society——

Mr. GOLDFINGER. Yes, sir.

Senator PROXMIRE (continuing). And you would schedule that, as I understand it, and those would be met—I may be a little wrong on this interpretation—those would be met in any event, but if we get into a military situation or some other kind of a situation that requires additional funds, then we increase tax. Is that correct?

Mr. GOLDFINGER. More or less. But it would depend upon the circumstances.

I don't think that we can discuss this in detail in a vacuum. We do have to discuss what the economic circumstances are in the country. But I do believe that if we had the kind of long-run planned expenditure programs in the areas of housing, comunity facilities, public services, that we could change the schedules up or down, we could change the pace of expansion, and that this is an important part of fiscal policy which unfortunately has been lost in the recent discussion of fiscal policy.

Senator PROXMIRE. You say you changed the schedules up and down on how you meet national needs?

Mr. GOLDFINGER. Yes.

Senator PROXMIRE. That's what I wasn't sure about.

Mr. GOLDFINGER. But I am not omitting the tax part of it.

Senator PROXMIRE. Isn't it difficult to vary your expenditures on a sound basis? If you are going to meet the needs for education, for example, the needs for the poverty program, you should not really interrupt them if you can possibly avoid it, because as you point out so well this can be not only disappointing but a serious long-term mistake, and very inefficient.

Mr. GOLDFINGER. Yes. But there are other forms of public construction which could be eased. Perhaps the construction of public buildings, such as post offices, or other buildings, could rather easily be postponed or speeded up. There are other things which have higher national priority and should not be cut back or slowed down.

But I firmly believe that on the basis of a longrun plan, we would know where we are going, and then we could make some judgment as to which should be speeded up and which should be slowed down, depending upon economic circumstances. Such planned effort in the Government expenditure field would relieve the pressures on tax policy.

I do not believe that we should be rushing in every year or every other year with additional tax changes. I think there should be greater reliance on the flexibility of Government expenditures, because, sir, I believe that the increase of Government outlays in these areas of education, housing, health care, community facilities, public services and so forth, are essential for the growth of the economy. They are essential to the growth of productivity, they add to the productivity of the economy, they add to the mobility of the labor force, they increase the skills of the labor force. These are important investments. Unfortunately too many people in the business community try to forget the importance of Government investment. These are investments of a crucial sort.

Senator PROXMIRE. At the same time you say that there is some Government spending that you think can be properly curtailed in the event of inflationary situations, and there are others on which you place a higher priority, and you would not curtail it.

Mr. GOLDFINGER. Right.

Senator PROXMIRE. This is fascinating, because we now have a situation in which the NAM and the Chamber of Commerce indicate they haven't any particular interests or any interests they want to call to the attention of this committee in reducing spending, and the AFL–CIO says, however, theoretically, that there are certain kinds of Government investment, Government spending you think could be cut.

Mr. GOLDFINGER. Not under existing circumstances. I am suggesting that it could properly be done only when you have longrun plans and when you have 5-, 10-, 20-year targets, instead of shooting in the dark as we are doing.

How can we rationally think of cutting the war on poverty, the antipoverty program, when the amount of money going into the war on poverty is just a tiny little sum of something like $1.5 billion, when so many of the other Government expenditures that we are making year by year are really tiny in terms of the need.

I would say that in terms of our need we should not be cutting them back, or freezing them—not only in terms of shortchanging the poor, but also in terms of the need to meet our public service requirements.

We have great needs in the area of health care facilities, in terms of educational facilities, in terms of air pollution, water pollution, the rebuilding of our metropolitan areas. These are needs which have been growing, and they should be met, and they can only be met by the Federal Government, in conjunction with State and local government efforts.

Senator PROXMIRE. Let me just ask you finally about guidelines. We haven't had much discussion here on that, and, of course, that is not front and center in what we are considering, but I think it is closely related to the inflationary situation.

Does the AFL–CIO have an official position—I have read in the newspapers about this—but can you speak authoritatively or with knowledge about whether or not they will support the proposed guidelines, or if they will not support them, would they feel restrained in any way in view of the inflation potential, in trying to hold wages down?

Mr. GOLDFINGER. The AFL–CIO Executive Council has a lengthy statement on this.

We believe that the guideline is unfair and unworkable. We have spelled out the various reasons why we believe that it is both unfair and unworkable. We certainly agree with some of the statements you made in your part of the joint committee's report.

The fact that the guidelines do not take into consideration the increase in the cost of living and poses a special burden on working people. If you look at the record, you will find that real earnings have lagged rather substantially behind the rise in the Nation's productivity.

Furthermore, the 3.2 percent guideline figure is not real. You have to deduct the increase in the cost of living from that. If the cost-of-living increase is somewhere about 2 percent, then the actual guideline is not 3.2 percent, but it is 1.2 percent in terms of buying power.

This is the imposition of an inequity upon wage and salary earners.

Senator PROXMIRE. But you accept the principle. In other words, if you were satisfied that these complaints of yours were taken into consideration, the guidelines were constructed on the notion of recognizing productivity increases, cost of living, and I guess there are some unions like UAW which have that in their contracts——

Mr. GOLDFINGER. Altogether too few.

Senator PROXMIRE. If you were satisfied with that, would you feel this principal is a viable and fair principal?

Mr. GOLDFINGER. Well, I'm afraid it is also unworkable, as we explain in our statement.

Senator PROXMIRE. It works pretty well when you consider what has happened in the last 4 or 5 years, compared with any other country in the world, and compared with what happened before we used guidelines, before 1961—when we had much sharper increases.

Mr. GOLDFINGER. Yes—however, Senator, the relative stability of the price level has been paid for, and it has been paid for by the working people of this country. In effect, the guideline asks the wage and salary earners of this country to bear the whole burden or the major burden for the stability of the price level.

Senator PROXMIRE. Yes. But they have gotten an increase in real wages and stable prices. That is a pretty good bargain.

Mr. GOLDFINGER. Yes. But the increase in real wages has lagged substantially behind the rise in productivity. I can give you the figures.

Senator PROXMIRE. I know that's true.

Mr. GOLDFINGER. And there has been a substantial and continuing lag.

Now, this indicates a shift in income distribution away from wage and salary earners to others.

Senator PROXMIRE. Why not let us try to work out something that is fair and at least work on it? It seems to me it is better to have that than to have an inflationary situation that hurts everybody, including the workingman.

Mr. GOLDFINGER. There is no effective price guideline, and there are no guidelines for profits, there are no guidelines for dividends, there are no guidelines for other forms of income.

Senator PROXMIRE. The administration has cracked down at least six times on industry in prices—steel, autos, aluminum, copper.

Mr. GOLDFINGER. But this, sir, is not an effective guideline. The guideline statement assumes that there are going to be price reduction in highly productive, highly profitable industries. We have not gotten those kinds of price cuts.

Senator PROXMIRE. It is awkward, it is rough, it is unfair in many respects; but it seems to me it is better than nothing.

I want to thank you very much. This is another stimulating and very helpful paper.

Representative GRIFFITH. Thank you very much. We are very happy to have you here.

Mr. GOLDFINGER. Thank you.

Representative GRIFFITH. This subcommittee will adjourn until Wednesday, March 30, 10 a.m., in this room, at which time our witness will be Stanley S. Surrey, Assistant Secretary of the Treasury.

(Whereupon, at 3:15 p.m., the subcommittee stood in recess until 10 a.m., Wednesday, March 30, 1966.)

TAX CHANGES FOR SHORTRUN STABILIZATION

WEDNESDAY, MARCH 30, 1966

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 recess, in room S-407, the Capitol, Hon. Martha W. Griffiths (chairman of the subcommittee) presiding.

Present: Representative Griffiths.

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

Representative GRIFFITHS. The room will be in order, and we will begin. We have invited Hon. Stanley S. Surrey, Assistant Secretary of the Treasury, to appear as a witness today. I will insert in the record at this point a copy of the letter sent to Mr. Surrey.

MARCH 22, 1966.

Hon. STANLEY S. SURREY,
Assistant Secretary, Department of the Treasury,
Washington, D.C.

DEAR MR. SURREY: On behalf of the Subcommittee on Fiscal Policy of the Joint Economic Committee, I extend to you an invitation to testify before the subcommittee on Wednesday, March 30, at 10 a.m., to assist the subcommittee in your capacity as a technical expert in the field of taxation.

In the course of the subcommitttee's hearings on the use of quick temporary tax changes for increasing economic stability, we have received a number of interesting proposals as to the form and content of such changes, as well as advice as to the economic impact of various alternatives. We believe you, as a technician, could be of considerable assistance to the subcommittee in evaluating these proposals. We should think there would be a number of considerations of their administration which would affect the technical feasibility of various alternatives. Furthermore, the witnesses who have appeared may inadvertently have overlooked some economic effects which we should be aware of in studying this problem. As the Treasury has given much thought to these matters, we believe your advice would be of considerable assistance.

Of course, under this arrangement we do not intend to question you about any policy issue concerning the use of such devices, or any specific device, in the current situation. Obviously, if the Treasury has proposals that it wishes on this occasion to lay before the subcommittee, we would be glad to receive them, but this is up to the initiative of the Treasury. I emphasize this point because the subcommittee's interest is in the question of whether or not it is possible to design a program that could be used both when a stimulus is indicated because of threatened or actual declines in economic activity, or, in the alternative situation, when there are obvious and present inflationary pressures. It is to this general problem that we invite your attention in your opening statement and about which we shall ask questions.

We have supplied you and your associates at the Treasury with copies of the transcript each day. We hope that between the last session today and next Wednesday you and your associates will have had ample time to consider the various ideas before the subcommittee and give us your best technical advice concerning the feasibility and economic effects of various possible alternative programs.

It would be most helpful if we could have 100 copies of your opening statement by noon on Tuesday, March 29, for use of the subcommittee members and the press. The session will be open to the public.

I look forward to seeing you next Wednesday.

Sincerely,

MARTHA W. GRIFFITHS,
Chairman, Subcommittee on Fiscal Policy.

Mr. Surrey, I am very pleased to have you here. I thank you very much for coming. It is understood by this committee that you will not be asked policy questions, but only technical questions on how you can raise or increase taxes, either to stop inflation or to stimulate the economy.

So you may proceed.

STATEMENT OF HON. STANLEY S. SURREY, ASSISTANT SECRETARY OF THE TREASURY; ACCOMPANIED BY MELVIN I. WHITE, DEPUTY ASSISTANT SECRETARY; AND GERARD M. BRANNON, DIRECTOR, OFFICE OF TAX ANALYSIS

Mr. SURREY. Thank you, Madam Chairman.

I have with me on my left Deputy Assistant Secretary White, and on my right, Gerard Brannon, Director of the Office of Tax Analysis.

If you don't mind, I would like to read through this statement.

Representative GRIFFITHS. Please do.

Mr. SURREY. I am very glad to participate in these hearings. I believe they are contributing significantly to a clarification of the issues, and to an understanding of the problems involved in designing short-range, temporary, tax changes for stabilization purposes.

In keeping with the committee's invitation, my comments will not be related to the present situation but rather to the general question of using tax changes to dampen down economic fluctuactions. Also for this discussion I will set aside the topic of long-range tax reform, and concentrate on the stabilization problem.

My own remarks will start from two premises: the first is that it would be desirable to use rapid tax changes for economic stabilization purposes, when such changes are needed. Along with monetary policy and shifts in the timing of Federal expenditures, tax variation has an important role to play in economic stabilization. We need all the weapons we can muster in our arsenal to combat economic fluctuations. The second premise is that by one arrangement or another the legislative processes will permit such temporary tax increases and decreases to be undertaken with sufficient speed to meet stabilization requirements. For my own part I would not disagree with a congressional decision to rely upon the regular legislative procedures, for we have seen that these procedures when necessary can permit rapid action. I will, therefore, confine my attention to the principles and technical problems and issues relating to the types and design of temporary tax change that might be undertaken.

GENERAL CRITERIA

Starting with general criteria, the essence of the kind of countercyclical tax action we are here concerned with is speed. As we all know inflation and deflation tend to become cumulative, feeding upon themselves and becoming harder and harder to stem or reverse as they follow their course. Yet while great improvements have been made in our economic forecasting methods, they cannot tell us—and given the dynamic world we live in I doubt that in the foreseeable future they will be able to tell us—what action is needed much in advance of the time when that action must be taken. We cannot therefore afford to be slow in taking action once it becomes clear that action is needed. Moreover, the action we take must make its effects felt very promptly. This need for speed and flexibility in stabilization policy points to three basic criteria for assessing specific countercyclical tax measures.

One is simplicity. To meet this requirement the method of tax change should entail a minimum modification of the normal tax collection and payments process. The tax change should be easy for the taxpayer to comply with and easy for him to understand. And, of course, it should be easy for the Internal Revenue Service to put into effect.

A second important criterion for judging the merits of alternative temporary tax changes is the immediacy and certainty of their economic effects. As I have already observed, there will not be much time to waste once a determination of the need for action is made. Tax action which is delayed in its economic effects even though taken promptly, may well fail in its purpose. In fact, given the speed with which the economic situation can sometimes change there is risk that action of such nature may even be perverse in the time of its effects and actually aggravate rather than diminish instability.

I believe that this criterion has an important bearing on the question of the extent to which short-range tax changes should aim at influencing investment or consumption. It is true that investment is the more volatile sector in our economy and it would be desirable to try to mitigate sharp fluctuations in the investment sector. On the other hand, evidence appears to indicate that the time lags between tax change and expenditure changes are substantially less and the effects are more certain for consumption than for investment. Consequently, for countercyclical tax policy it is probably advisable to aim at both consumption and investment but to place primary reliance on influencing consumption.

As a third general criterion to apply to the choice of temporary tax changes, the design of countercyclical changes should be such that the changes can be assured of ready and therefore speedy general acceptance. Proposals that provoke controversy, or that, because of their novelty or complexity, require considerable study to understand and appraise must inevitably cause delay in taking action and therefore cannot really be fitted into a policy of temporary countercyclical tax changes.

Closely related to acceptability is the criterion of symmetry. If legislation is to be rapidly enacted, the Congress and the public must be assured that the legislation does not involve making longrun permanent rate changes in the tax system. This consideration requires that the changes be temporary. If after a year or so the change is no longer needed, it should come off in the same way that it went on. If on the other hand it develops that the increase or decrease in revenue needs will be permanent—as far as anything can be "permanent" in a tax system—it should be understood that the temporary change itself will expire and be replaced by a longrun tax change developed in the usual way and including whatever structural changes the Congress might think appropriate.

Even temporary changes, however, still involve the problem that different types of change are available and a voter is apt to choose among them on the ground of which one affects him most favorably. But it may be that a type of change that is relatively favorable to a group of taxpayers when an increase is required will become relatively unfavorable when tax reduction is called for.

It has therefore been suggested that the prospects for general agreement on the available types of change might be improved if a further principle of symmetry is advanced that countercyclical tax decreases should be the mirror opposite of tax increases. Under this principle, tax changes may work to the relative advantage of some people in some stages of the economic cycle but not at others, and the tendency would thus be neither to favor nor disfavor any group over the full course of upswings and downswings. However, in view of the many considerations that enter into the formulation of fair and effective tax changes there is a question as to just how much weight to give to this version of the symmetry principle. Perhaps a more flexible interpretation that permits the inflationary and deflationary phases to be treated somewhat differently might prove more realistic and useful. At least, I would leave this particular aspect of symmetry as an open one to be considered after we have learned more about the entire process of these stabilization tax changes, rather than regard it as a governing concept.

STRUCTURAL CHANGES UNSUITABLE

If these criteria can be considered valid guides for the choice of countercyclical tax measures, it seems clear that proposals which involve structural changes in our tax system are usually of doubtful appropriateness. Or, to put the matter another way, only those structural changes which are readily and generally acceptable, whose effects are immediate and predictable, and which are relatively simple to implement, ought to be considered in connection with short-run stabilizing tax policy. This presumably renders ineligible many of the longstanding and thus usually controversial proposals for tax reform.

I think it also precludes adding to our existing structure in such a process a new type of tax, whether the tax is to provide additional revenue or to permit reduction in yield from existing sources. A new tax always involves a number of basic policy questions which are far more numerous than is usually perceived or recognized when the tax is proposed, and which cannot properly be considered at the same time that attention is being given to temporary stabilizing tax changes. To illustrate this point, I would like to submit as an appendix to this statement, a memorandum which sets forth some of the policy decisions involved in formulating the structure of a value added tax, which tax has been proposed during the course of the committee's hearings.

This should not be construed to preclude consideration at appropriate times of possible modifications of the present structure that would make it more amenable to implementing a flexible tax policy. For the present, however, I think it advisable to focus on what can be done within the existing structure.

Let me now turn to some of the technical issues that would be involved in temporary changes of specific taxes within our existing structure.

INDIVIDUAL INCOME TAX

On the basis of the criteria of immediacy and certainty of economic effect the individual income tax is probably the most suitable for implementing temporary changes in tax rates. Due to the withholding feature of the tax, a very quick impact on the disposable income of individuals can be achieved. Indeed, the sensitivity of this withholding procedure has been increased through the recent adoption of a graduated withholding system. In turn, the influence of changes in current disposable income on consumer expenditures is probably the most prompt and most reliable influence on aggregate demand that fiscal policy has to work with, whether for short-run changes up and down or for longer range changes in the level of demand.

There are numerous ways by which temporary changes in the individual income tax can be produced. One approach suggested by the criteria of simplicity and ready acceptability is to devise a "neutral" type of short-range tax change. By "neutrality" is meant a tax change that does not attempt to alter the general progressivity of the tax as it exists before the change. Since a number of witnesses have spoken about this neutrality, some discussion of its technical aspects is in order.

"NEUTRAL" CHANGES

Neutrality is itself subject to alternative interpretations. One interpretation appealing as a theoretical matter to some economists calls for a tax change equal to a uniform percent of the "disposable income" of taxpayers; that is, the income they have available to spend on goods and services or to save. This approach would leave the relative position of taxpayers measured by their disposable income unchanged.

That is, if one individual had 50 percent more disposable income than another before the tax change, he would still have 50 percent more after the tax change.

There are some important practical difficulties with this method, however, which are discussed in the footnote, which I think preclude its use for countercyclical purposes.[1]

[1] A definition of "disposable income" would be required whereby the amount for each taxpayer can be determined with the precision needed for a tax measure. Drawing on present tax devices, "disposable income" might be defined as the adjusted gross income of a taxpayer minus his tax liability. "Adjusted gross income" is roughly earnings and business net income before personal exemptions and personal deductions. But under this definition, a temporary tax turning on disposable income cannot be built into either the rate structure, essentially because our statutory rates apply to taxable income, or into the present withholding structure which allows for personal exemptions and deductions. To illustrate, consider a group of married couples all having the same taxable income but, due to differences in itemized deductions and/or family exemptions, have different amounts of adjusted gross income. They would all be liable for the same amount of income tax, as computed from the existing rate structure. However, their disposable incomes, as above defined, would differ one to the other. Hence, under a uniform percent of their respective disposable incomes, the amount of the temporary tax increase or decrease will vary from one couple to another. But since their taxable income does not vary, this tax change could not be stated in terms of the rate structure, which applies to taxable income.

Thus to compute the temporary tax under this uniform percent of disposable income method, separate computations would be required by the individual on his return and by the employer for withholding purposes.

Another complication under this method, if strictly pursued, is that in periods calling for a tax increase, individuals who otherwise would be nontaxable should nevertheless become liable for the temporary tax, and in periods calling for a decrease, nontaxable individuals should benefit from a disbursement from the Treasury. While the logic for these computations may be clear to the economists, it probably would not be readily understood by the average taxpayer.

There are two other simpler methods of implementing individual income tax changes that may also be interpreted as "neutral."

One of these is a uniform point change in tax rates in each bracket. This method may be considered "neutral" since the tax change amounts to a uniform percentage of everyone's taxable income. That is, if all the existing bracket rates were increased by 1 point, an individual with $2,000 of taxable income would pay $20, and an individual with $10,000 of taxable income would pay $100. Also, since all brackets would be increased by 1 point, the differences from one bracket to another would remain the same as before the tax change.

Another "neutral" method of changing taxes is by means of a uniform percentage change in tax liabilities. Under this method the relative amount of tax paid by each individual is the same after the tax change as before the change. Thus, under an increase, if one individual's tax liability is 10 percent higher than another's before the change, it will still be 10 percent higher after the change.

The comparative effects of these methods on taxpayers at various income levels is illustrated in the attached table.

(The table referred to follows:)

Illustration of 3 tax change formulas with a $2.5 billion revenue effect (married taxpayer, 2 children, 10-percent deductions or minimum standard deductions)

AGI	Taxable income	Tax present law	AGI after tax	Uniform percentage change in tax liability (5 percent)		Uniform point change in tax rates (1 percent)		Uniform percentage change in disposable income (0.66 percent)	
				Tax increase (+)	Tax decrease (–)	Tax increase (–)	Tax decrease (–)	Tax increase (+)	Tax decrease (–)
$2,000	0	0	$2,000	0	0	0	0	+13	–$13
$3,000	0	0	3,000	0	0	0	0	+20	–$20
$4,000	$1,000	$140	3,860	+$7	–$7	+$10	–$10	+25	–25
$5,000	2,000	290	4,710	+14	–14	+20	–20	+31	–31
$7,500	4,350	686	6,814	+34	–34	+44	–44	+45	–45
$10,000	6,600	1,114	8,886	+56	–56	+66	–66	+59	–59
$12,500	8,850	1,567	10,933	+78	–78	+88	–88	+72	–72
$15,000	11,100	2,062	12,938	+103	–103	+111	–111	+85	–85
$25,000	20,100	4,412	20,588	+221	–221	+201	–201	+136	–136
$50,000	42,600	13,388	36,612	+669	–669	+426	–426	+242	–242

The table shows how a married couple with two children taking 10-percent standard deduction would fare at various levels of adjusted gross income under a hypothetical tax change that in the aggregate would involve $2.5 billion. Solely for purposes of comparison as to the distribution of the tax change, the uniform percentage of disposable income method is also included in the table.

There it can be seen that at incomes of $3,000 and under where no tax is imposed under present law, neither the uniform percentage of tax liability nor the uniform point change in rates methods would, of course, cause any change in tax liability up or down; the uniform percentage of disposable income method would produce tax changes for these incomes. Beyond this level, the uniform percentage of tax liability method would impose larger tax increases on higher incomes and smaller tax increases on lower incomes than either of the other two methods. Symmetrically, this method would provide larger tax reductions for higher incomes and smaller tax reductions for lower incomes than either of the other two methods. Under the uniform point change in rates method, the differential increases and decreases as between higher and lower incomes fall in between those for the other two methods. Thus for the taxpayer with $4,000 of adjusted gross income, under the uniform percentage of tax liability method the tax would rise or fall by $7; under the uniform point change in rates the tax would rise or fall by $10; and under the uniform percentage of disposable income method the change would be $25. For the $50,000 income, the respective tax changes under the three methods would be in reverse order of magnitude: $669, $426, and $242.

I also have included a table which compares the rate structures that would implement the two alternative methods of changing tax liabilities up or down by $2.5 billion.

(The table referred to follows:)

Illustrative rate structure for alternative income tax changes (approximately $2½ billion)

Taxable income bracket (single person)	Present law rates	Uniform 5-percent change in liability		Uniform 1-point change in rates	
		Increase	Decrease	Increase	Decrease
0 to $500	14	14.7	13.3	15	13
$500 to $1,000	15	15.8	14.3	16	14
$1,000 to $1,500	16	16.8	15.2	17	15
$1,500 to $2,000	17	17.9	16.2	18	16
$2,000 to $4,000	19	20.0	18.1	20	18
$4,000 to $6,000	22	23.1	20.9	23	21
$6,000 to $8,000	25	26.3	23.8	26	24
$8,000 to $10,000	28	29.4	26.6	29	27
$10,000 to $12,000	32	33.6	30.4	33	31
$12,000 to $14,000	36	37.8	34.2	37	35
$14,000 to $16,000	39	41.0	37.1	40	38
$16,000 to $18,000	42	44.1	39.9	43	41
$18,000 to $20,000	45	47.3	42.8	46	44
$20,000 to $22,000	48	50.4	45.6	49	47
$22,000 to $26,000	50	52.5	47.5	51	49
$26,000 to $32,000	53	55.7	50.4	54	52
$32,000 to $38,000	55	57.8	52.3	56	54
$38,000 to $44,000	58	60.9	55.1	59	57
$44,000 to $50,000	60	63.0	57.0	61	59
$50,000 to $60,000	62	65.1	58.9	63	61
$60,000 to $70,000	64	67.2	60.8	65	63
$70,000 to $80,000	66	69.3	62.7	67	65
$80,000 to $90,000	68	71.4	64.6	69	67
$90,000 to $100,000	69	72.5	65.6	70	68
$100,000 and over	70	73.5	66.5	71	69

Mr. SURREY. However, it would not be necessary to modify the present rate structure in order to implement either method. If desired, each could be expressed as a separate tax on the return—a percent of tax liability or a percent of taxable income, added on to the present law tax.

To put either the uniform percentage of tax liabilities change or uniform point change in tax rates into effect, new withholding percentage formulas and new withholding wage bracket tables would be needed. This can be done accurately, since either method can be translated into increased tax rates.

The necessary revision in the withholding rates would require the Internal Revenue Service to print the new withholding percentage formulas and the new withholding wage bracket tables and distribute them to employers. Employers who utilize computers would need time to reprogram them. A minimum of 30 days should be allowed for all this; around 22 days for the Internal Revenue Service to prepare and distribute the new material and about 8 days for the employers to put the change into effect. Presumably, there would be a period before the bill becomes law through Presidential signature (but after the rates become firm) during which the Service could begin its work, so that a period of 30 days from enactment date is not required. It should be noted that employers have been given about 30 days to effect the changeover this year from flat rate withholding to the new graduated plan.

However, this longer period is needed since they must obtain new withholding exemption certificates from their employees. There would be no necessity for this in changing over from one graduated rate structure to another; therefore, 8 days seem sufficient for employers under these circumstances. This was, by the way, the period allowed employers for the change-over under the Revenue Act of 1964.

In general—and this is the significant point in all this technical discussion of neutral methods—one should really not exaggerate what amounts to fine points of difference between the uniform percentage change in tax liability method and the method providing a uniform point change in tax rates. Each is simple to express in the tax return and to understand. Each therefore seems appropriate as a method for countercyclical change in the individual income tax.

ECONOMIC EFFECT

With regard to the economic effectiveness of temporary individual income tax changes, the relevant consideration is the impact within a relatively short period of time and within the context of a cyclical up or downswing. In this context, expectations can be very important; and if a countercyclical fiscal policy is followed, it in itself will have an influence on expectations. If the policy inspires confidence that it will succeed in dampening fluctuations, then the expectations it generates will be favorable. In a downswing, consumers may be buoyed up by anticipation of the tax cut, and also by anticipation of its success in stemming the decline. In a boom period, consumer expenditure may be abated by expectations of counterinflation tax policy. Such behavior would also, of course, have an impact on investment.

Some economists have argued, on the other hand, that a temporary change in tax rates might be less effective than a permanent one, because it might not lead consumers to alter their established spending habits or lead businessmen to change their sights on long-term rates of return on investment. Such factors may be relevant, but they may still be considerably outweighed by the important confidence effects of adjusting fiscal policy appropriately to changing economic circumstances. These confidence effects cannot be included in any statistical estimates of the likely magnitude of the short-range effects of a tax change on GNP. As to the quantitative estimates that can be made, I gather that economists would judge roughly that within two to four quarters after the effective date, the impact on the annual rate of GNP would range between $1 billion and $2 billion per $1 billion of change in individual tax liabilities.

CAPITAL GAINS

With regard to capital gains, the question is whether or not the tax rate should go up or down with personal income tax rates. Capital gains which are not taxed at the ceiling rate of 25 percent are taxed at a rate which is in effect 50 percent of the marginal income tax rate. It seems reasonable to continue the 50 percent inclusion rule during a temporary tax change since the gains would be subject to temporary tax increase or decrease in proportion to the tax change on other income.

As to whether the alternative ceiling rate on capital gains, that is, the 25 percent rate, one could raise the question whether the occurrence of a temporary increase or decrease might cause investors to speed up or slow down sales that they would have made in the near future. Balance changes of a point or two in the ceiling rate seem unlikely to have this effect. This issue might well be decided on the basis of the general attitude toward the fairness of including the ceiling capital gains rate in a program of temporary changes in the individual income tax.

LOW INCOME TAXPAYERS

An interesting departure from simple, symmetric up and down changes in rates was proposed to the committee by Professor Carl Shoup. He suggests that, for the anti-inflation phase, low income taxpayers be excepted from the increase. They would, of course, then get no benefit when the increase was taken off. As a technical matter, this could be done in a number of ways. Using Professor Shoup's suggested levels, all the surtax rates could be raised except the first few. Or the increase might be expressed as a percentage of that part of an individual's tax that exceeded, say, $300, or some percentage of the part of his taxable income that exceeded, say, $2,000. This is using Professor Shoup's figures, the device might be structured to exempt only low income taxpayers, and not thereby extend the benefit of the exception to taxpayers in higher brackets, though this would probably require somewhat complicated knowledge.

To illustrate the effect of this suggestion, consider that initially a uniform 5-percent increase in all tax liabilities is planned, designed to raise $2.5 billion in revenues. Then suppose the plan were modified to impose no tax increase on the first $300 of tax liability of married couples and no increase on the first $150 of tax for single individuals. The result of this modification by itself would be to reduce the overall revenue increase by $600 million, of which about $160 million would benefit married couples with less than $2,000 of taxable income, and single persons with less than $1,000 of taxable income. The maximum individual benefit would amount to $15.

To offset the revenue loss, the percentage increase would now have to be raised from 5 to 6.5 percent. The net effect of shifting from the alternative of a uniform 5-percent increase in all liabilities to a 6.5-percent increase on tax liabilities in excess of $300 for married couples can be illustrated in terms of a married taxpayer with two dependents using the standard deduction. No tax increase would be imposed on this family under the 6.5-percent formula, if its adjusted gross income were $5,000 or under; if its AGI were between $5,000 and

$9,500 the increase under the 6.5 percent alternative would be less than under the 5 percent (with no exemption) alternative, and more than under the 5 percent (with no exemption) alternative if the family's income exceeded $9,500.

CORPORATION INCOME TAX

Turning now to the corporate income tax, there are a number of reasons—both economic and equity—for considering the corporate income tax in a balanced package of contracyclical income tax changes. Broad neutrality as between individuals and business, which is predominantly corporate, is probably desirable.

Moreover, individual income tax rate changes would apply to unincorporated businesses. Appreciable disparities in the treatment of corporate and noncorporate enterprise would affect the choice between the corporate and noncorporate form of business organization in the important area of small- and medium-sized businesses. Furthermore, most observers—including both expert and nonexpert opinion—believe that if higher burdens are placed on individuals in response to economic conditions, even though the emphasis may be on curtailing consumption, corporate business should be called on also to make some contribution. Changes in corporate tax payments may influence both dividend payments and investment outlays. This belief probably does not apply with the same force to tax decreases during a downswing. Still, reduction in the corporate tax paralleling that in individual income taxes may be appropriate to maintain a simple symmetry over the cycle and also because of its economic effects.

Changes in corporate tax can be made in a manner more or less parallel to the changes discussed for the individual income tax. A simple change in the tax applying to all corporations could be achieved on either the point change method or the percentage of tax liability method. In the case of a point change, the normal tax rate, which is now 22 percent, could be changed by the desired number of points. At presently projected 1966 levels of income and profits, a 1-point change in the normal tax would produce approximately a $700 million change in corporate tax liabilities. This figure is net of an offsetting small change ($40 million) in tax yield from the assumed effect on dividends.

As an alternative, a uniform percentage change in corporate tax liabilities might be used. The percentage comparable to a uniform 1-point change would be a 2⅓ percentage change in tax liabilities. which would also produce a revenue change of $700 million. As compared to the 1-point change in the normal rate, this method would produce a larger increase and a larger decrease in tax liabilities of large corporations, and a smaller increase or decrease in the liabilities of smaller corporations.

A 1-point corporate rate change confined to the surtax rate would produce a change in yields of about $630 million. This would exempt small corporations from participation in the countercyclical policy. However, any merit that may inhere in the exclusion of low-income groups from a temporary increase in the individual rates does not appear to carry over to the corporate sector. Moreover, varying the spread between the normal rate and the surtax rate would aggravate the tax preference for multiple surtax exemptions.

With regard to economic effectiveness of changes in corporate rates, a temporary change in corporate taxation works primarily through its effects on cash flow, a key factor in investment calculations and decisionmaking. Cash flow is usually measured after book accruals of tax liability. But the available flow of corporate spending is also influenced by actual tax payments, particularly in periods of (*a*) monetary restraint or (*b*) hesitancy on the part of business to borrow.

The fully current tax payment system for corporations introduced in the 1964 Revenue Act, the transition to which will be made by 1967 under the accelerated payment provisions of the Tax Adjustment Act of 1966, just enacted by the Congress, insures that the actual cash payment and cash flow effects of corporate tax changes will make themselves felt promptly. By 1967, all corporate taxes in excess of $100,000 will be subject to declaration and payment of estimated tax beginning in April of the current income year for a calendar year corporation.

No more than 30 days would be necessary to implement a corporate tax change through notifying all corporations of the applicability of new rates. The effect on aggregate demand and GNP would almost certainly be slower than from a change in the individual tax rate, although again expectations factors of a reinforcing nature would probably be operative as a result of anticipation of the countercyclical policy The magnitude of the short-run effect is certainly no easier to estimate than for changes in the individual rates. Perhaps the GNP effect, at annual rate, would reach $1 billion per $1 billion of tax change, within 4 quarters after the change went into effect.

EXCESS PROFITS TAX

The excess profits tax is generally recognized as an inherently defective tax and barely satisfactory as a taxing instrument in periods of severe defense emergency. The prospect that an excess profits tax would be reactivated from time to time in a peacetime economy as a countercyclical measure would have serious adverse effects on business planning.

New businesses and new risk ventures would face the prospect of severe marginal tax rates on the rewards of success whenever they coincided with exuberant upswings in the economy. Such a prospect would have deterrent effects on growth and innovation.

New ventues and expansion would tend to be undertaken only within the framework of corporate entities which would be expected to enjoy a favorable position with respect to an excess profits tax, because of available historical earnings records, invested capital structures, or eligibility for accustomed special relief features. The timing of deductible expense outlays would be arranged to maximize the costs deducted in excess profits tax periods, thus accentuating economic strains in a period of high prosperity. Production of new or scarce items likely to yield temporary high profits would tend to be inhibited during excess profits years, with the consequence that shortages would be aggravated in these periods. Disproportionate energies would be devoted to the planning of business activity within the protection of various excess profits tax shelters.

INVESTMENT CREDIT

Turning now to the investment credit, the possibility of changes in the investment credit received considerable attention during these hearings. Some economists have stated that investment demand may be reaching excessive levels, either because it strains our capacity for producing more plant and equipment or because it generates a capacity for producing final goods in excess of the economy's long-term needs.

These economists have contended that the very factors that made the investment credit a particularly successful stimulus to investment now recommend its modification or suspension in order to moderate an overly buoyant investment demand. A temporary suspension could, they argue, have especially favorable effects in encouraging business firms to defer investments to a period when they might be more appropriate to the state of the economy.

Without entering the argument of whether the present level of investment demand is excessive, I would like to indicate that there are structural and other aspects of the investment credit which need to be considered in evaluating its possible countercyclical use.

I would like to point out first that, in the recent debate in the Senate over suspension of the credit, those who advocated suspension felt required, and understandably so, to still allow the credit with respect to machinery and equipment already on order. This would remove a large area of current and future expenditures from the scope of the suspension and thereby reduce its current economic and revenue effect. At the other end, the fact that the credit is earned when the equipment is installed—and not when the equipment is ordered or when expenditures for it are made—would always leave the credit still applicable to orders entered during the suspension period for equipment whose leadtime would place the installation after the suspension was over.

This also reduces the scope of the suspension. Moreover, the equipment left to be affected by the suspension—that both ordered and installed in the suspension period—in large part would be the sort of machinery and equipment, that, in coming onstream, would be helpful in meeting shortages.

Actually, I think people who have advocated suspension of the credit really have an image of its operation that would have it turn on orders rather than installations as it now does. This possibility was explored at the time the credit was originally set up and found not to be feasible.

Many advocates of suspension of the credit have also thought of the suspension as part of a program that would include both individual and corporate tax increases. In such a program, to the extent the suspension of the credit would be effective, the question would have to be considered whether this action, taken together with the rest of the program, would provide too much restraint on investment.

Also, it must be kept in mind that the investment credit has a long-run purpose of stimulating modernization and expansion of machinery and equipment. This is necessary to give us the industrial structure needed to meet our domestic growth needs, to fulfill our international obligation, and to maintain the strong competitive position required for our balance-of-payments goals.

Indeed, countries such as the United Kingdom and France with their own problems of inflationary pressures are currently moving to provide incentives to business investment.

So far I have discussed the counterinflationary aspects of a change in the credit. But there are analogous questions with respect to temporary increases in the credit to counterdeflationary forces. A temporary increase in the investment credit rate, say, from 7 to 10 percent would result in an unexpected windfall on outstanding commitments which had been made in expectation of the existing 7-percent credit but which would receive an additional 3 percent. As a result, the increase would, in effect, be retroactive, particularly with respect to the portion of the costs of assets placed in service during the increase period which represented expenditures or costs allocable to a prior period. At the same time, the retroactive feature of such an increase would be necessary and desirable to assure that the prospect of getting a higher credit in a depressed period would not lead to delays in investment and slowdowns of projects already underway at a time when some increase in the credit might be expected.

A temporary increase in the credit would stimulate chiefly short leadtime items which could be completed with some confidence in the increase period. Apart from its contribution to corporate cash flow, the increase would not effectively stimulate investments, completion of which would take some time, leading to an installation after the credit had reverted to its normal level.

The way a credit increase would help to combat recession would be primarily to hasten to completion projects already underway and to stimulate demand for individual standard pieces of equipment, such as trucks, fixtures, and office equipment. Any use of a temporary increase in the investment credit as a counterrecessionary measure would depend upon the development of sufficient retroactivity to insure that the prospect of an increase would not add to uncertainties during periods of economic hesitancy and would not slow down investment in such a way as to aggravate depressed conditions of investment demand.

In considering countercyclical variations in the investment credit, it is important to recognize that investment demand will be influenced by corporate tax changes and—indirectly but possibly even more significantly—by variations in individual income tax rates. These effects would cover a wider range of investment—including inventories and accounts receivable—than would a change in the investment credit. Changes in the investment credit would concentrate on machinery and equipment acquisitions. The proportion of total corporate plant and equipment outlays eligible for the credit in 1963 was about 60 percent, and a share of this was subject to only the 3 percent rate of credit applicable to certain public utilities.

In general, decisions in this area must involve the question of whether the concentration on a particular sector of business outlays or whether a comprehensive approach to influencing business outlays would be more effective in serving the needs of economic stabilization.

USE OF EXCISES FOR COUNTERCYCLICAL PURPOSES

Turning now to use of excise taxes for countercyclical purposes, an attempt to include excise tax changes as part of a countercyclical tax program would give rise to a number of problems and difficulties.

A major problem would arise from the fact that the Federal excise system as of now is made up almost entirely of three groups of taxes, (1) the sumptuary taxes on liquor and tobacco; (2) user charges and dedicated taxes; and (3) regulatory taxes.

In addition, there are the taxes on new passenger automobiles and telephone service. But the telephone tax under present law is scheduled to be repealed in 1969. As for the automobile tax, the President has recommended that the 1-percent tax which will remain in 1969 be dedicated to the highway trust fund to pay the costs of the programs of highway safety and beautification.

This threefold classification of the excise system severely limits the adjustments that could be made to the existing excise taxes for countercyclical purposes. The regulatory taxes raised little revenue and do not lend themselves to adjustments for revenue purposes. Those taxes that are levied as user charges or whose revenues are dedicated to special purposes also do not readily lend themselves to anticyclical adjustments. The taxes are designed to charge users with the cost of certain public expenditure programs, and their use in a countercyclical manner might be considered discriminatory and inequitable. To raise charges above user cost levels in an inflationary period would be a form of discriminatory penalty tax on the users of the services; a reduction below user costs levels would in effect be a subsidy to the users of the service. It is questionable if public policy would be well served by alternatively penalizing and subsidizing, for example, users of the Federal airways system and thus air transportation.

It would be possible to revise liquor and tobacco taxes up and down according to cyclical revenue policy (the British have done this a number of times), but there are constraints on how much could be done. Taxation of liquor and tobacco is supported by the public for sumptuary as well as revenue reasons. At the same time, the policy has been to avoid severely depressing these industries. If the desired fiscal policy called for a reduction in Federal tax rates, sumptuary considerations might argue against a drastic reduction in alcohol and tobacco taxes. On the other hand, while fiscal considerations might warrant substantially higher tax rates in general, the effect on the alcohol and tobacco industries might lead to little or not tax increase on their products.

Finally, taxes that affect prices always incur the danger of setting up perverse expectation effects. If consumers anticipated that prices were going to rise as a result of an increase in the tax, they would accelerate their purchases, thereby aggrevating inflationary pressures. On the downside, they may hold back purchases in anticipation of tax reduction, thereby aggrevating the decline at least in the early stage before the decrease in tax was actually in effect.

In view of the structure of the present excise system then, it would be difficult to utilize existing excises as much of a countercyclical measure. Nor would it be at all desirable to impose new selective excises or reinstitute those that have been repealed. The excise tax action of last year was properly based on the idea that the Federal tax system should deemphasize selective excises, because of their regressive, and discriminatory effects, and because they often pose compliance difficulties.

PAYROLL TAXES

Finally, to come to the payroll tax, the payroll tax is connected with the social insurance system, and countercyclical changes in contribution would seem inappropraite. Increases in the tax would put a relatively large burden on low-income workers and would scarcely be neutral.

At the same time, the employer's portion is closely related to costs, and it would be uncertain as to how changes in the employer's tax would affect business behavior and prices.

The timing of otherwise desirable payroll tax changes must, however, be considered in light of economic conditions so as to avoid a destabilizing economic impact. There may be opportunities to alter the timing of such changes to assist economic stabilization without conflicting with the longrun principles of financing appropriate to the social insurance system.

(The appendix referred to follows:)

APPENDIX

SOME POLICY DECISIONS INVOLVED IN FORMULATING THE STRUCTURE OF A VALUE-ADDED TAX

1. Scope of tax

Would the tax apply to the corporate sector only or cover unincorporated businesses as well?

Would the tax apply only to manufacturing and distribution of goods? Or would it also apply to services, including domestic service, casual labor, legal, medical, accounting, and various other personal and professional services? Should retailing be included, in view of widespread State and local retail sales taxes?

2. Special rates and exemptions

Should the tax apply uniformly at a standard rate to all goods and services or should it be differentiated, as in France, so as to bear more lightly on "necessities" as against "luxuries"?

Should exemptions be provided for certain end-products such as fuel and medicine? Or for certain uses of end-products such as purchases for use of churches, schools, hospitals, and charitable or scientific institutions?

Should relief be granted particular industries with unusually high value-added margins?

3. Agriculture and small business

Should farmers, shopkeepers, barbers, bakers, restauranteurs, cleaners and laundrymen, tailors, radio and TV repairmen, or small businessmen generally be required to pay the value-added tax?

Should other vertical or horizontal exemptions be provided, i.e., by size of business or by type of activity? If so, at what size level (sales volume, employment, etc.) should the exemption be determined?

4. Financial, real estate, and royalty income sector

How should interest, rent, and financial intermediaries be treated under the tax? Presumably interest and rent payments would normally be taxed as costs to the payor. If interest is taxed generally as a cost or value-added item, would this rule work hardship on interest-paying financial intermediaries such as banks. life insurance companies, and similar savings institutions, a large part of whose costs are interest payments to depositors, policyholders, etc.?

Should rents of real estate enterprises owning apartment houses, office buildings, and commercial industrial properties be taxed? Should the tax be imposed on the rent payor or payee?

5. Definition of the value-added base

Should all depreciation or expenditures on capital goods be disallowed as costs (gross national product type of value-added tax)? Or should depreciation be allowed on depreciable assets ("income type" of value-added tax)? Or should the entire purchase of depreciable assets be deducted as a cost ("consumption type" of value-added tax)? If the consumption type of tax is adopted, how is the transition handled with respect to preexisting assets which were not deducted at purchase or previously depreciated for purposes of the new tax?

6. Mechanics of application

Should the tax be applied (1) to value-added defined as sales less deductions for previously taxed purchases, (2) to the entire sales of the firm, as in France, subject to a credit for value-added tax paid on purchases invoiced to the purchaser, or (3) directly to value-added costs (i.e., wages, interest, previously untaxed purchases, etc., plus profits)?

7. Rebate on exports

Presumably imports would be taxed in full while exports would be eligible for rebate of cumulative tax paid on the exported commodity. How is the export rebate effectuated? By refund only to the exporter? By refunds tracing taxes back to each of the firms which have contributed to the export value as the goods moved through the various stages of production and distribution?

How will "reexports" containing previous imports be handled? How will "re imports" containing previous exports be handled?

8. Special income and cost problems

Should capital gains be included in the value-added base? (If not, potential profits taxable under the value-added tax could be capitalized by sale and removed from the value-added base.)

Should depletion be taxed as a value-added item? If deductible, how should depletion be calculated for value-added purposes?

Should special treatment be accorded "fringe benefit" compensation, including pension trust contributions and profit-sharing benefits?

Should taxpayments of any kind be excluded from the firm's value-added base? Should different taxes be treated differently?

9. Public enterprise, tax-exempt institutional activity, and cooperative and mutual enterprise

Should the value-added tax be applied to Government-owned enterprise? to enterprise conducted by tax-exempt institutions? to cooperatives and mutuals? How should clubs (bars, restaurants, recreation facilities) be treated?

10. Reporting and collecting procedures

Would the value-added tax return be integrated with the regular income tax or treated as a separate tax? How would current reporting and taxpayment be carried out? on a monthly basis? quarterly basis?

11. Effect on structure of other taxes

What effect would a change in the corporate tax as a consequence of a partial shift to value-added taxation have on other parts of the tax system, such as the tax on capital gains of individuals?

Mr. SURREY. That concludes a rather lengthy statement.

Representative GRIFFITHS. Thank you. It is a very good statement, too, Mr. Secretary.

I would like first to ask you, concerning the effect, the immediate effect, of a corporate increase, or the repeal of the investment credit, as opposed to the immediacy of the effect of a tax on consumers, of an increase the tax for consumers.

The other evening, I happened to see an investment program by a large company, laid out through 1971. They showed me where they were going to get the money, they counted the investment credit at 14.5, and how they were going to repay that money, through a period of 5 years. It was a tremendous program.

Now if those people were immediately hit with a large tax increase, that program is going to change, right then. They have real ability. They know exactly what they are doing.

Would it or would it not be more effective, more quickly, than any other type of tax increase or decrease?

Mr. SURREY. Well, I think that depends on how quickly these programs do change, and this can well vary from company to company. Programs that are already underway are not likely to be affected.

A new program, that is still on the drawing boards, one that is planned for 4 or 5 years ahead, might be delayed in its start. It is rather difficult to generalize in this respect, other than to say that the general feeling of most economists would be that there is an appreciable lag between the change in corporate rates up or down and the time when their effect is felt in company planning, and, in turn, when the effects of change in company planning are felt on the economy.

It may well be that the program of a company would respond more quickly to changes in speeding by individuals, compared to what they thought the future level of demand for their product would be. That might even be more quick.

Representative GRIFFITHS. Well, it just happens in this case, they have a constant demand, over a long period of years. All they have to do is consider how many people they are going to serve, so I really don't think that they are going to be affected at all.

Mr. SURREY. Yes. Well, then, in that case it would be just the cost of their program that affected their planning.

Representative GRIFFITHS. With them, but they might be very strongly affected by an increase in corporate rates, or the repeal of investment credit.

Now I would like to ask you, can you now estimate how long it took the corporate tax increases, the depreciation guidelines, the investment credit, and reduced corporate rates to take effect?

Mr. SURREY. That would be pretty difficult to estimate and certainly to isolate the effects of any one of these, because they are reinforcing. There have been, as I said, some general estimates as to what the effect of a change in the corporate rate would be on the economy, and as I indicated in the statement, just judging from what economists thought in the past, a billion-dollar change in tax rates would have a billion-dollar GNP effect in about four quarters.

Now that is just a change in corporate tax rates.

The investment credit has its own timing problems, because of the way it is structured, as I indicated in my statement, and it is more difficult to estimate what the effect of that would be.

The initial effects of the investment credit and the changes in depreciation guidelines perhaps started rather slowly, because at that time, there was uncertainty as to final demand, but once there was a strengthening of consumer demand, then, the entire process—consumer demand, the investment credit, and the guidelines—all reinforced each other, and the effect was rather dramatic over the last few years.

Representatives GRIFFITHS. Yes; it seems to me that really, by adding tax cut to tax cut to tax cut, we have really created our own problems, without waiting to find out what the effect of all these tax cuts is going to be.

Now yesterday on the floor, as I listened to the argument, I could not refrain from thinking that in spite of the fact that Vietnam has practically no effect in the total gross national product, if tomorrow you started negotiating, what we would need by Friday would be a very substantial tax cut.

Yet you would begin immediately to consider how you stimulate demand and how you stimulate confidence that you are going to continue to have a boom.

Professor Brown suggested that because changes in tax rates schedules are regarded as permanent, fiscal measures to stimulate or restrain spending tend to be taken too late. Do you think that the fiscal policy is too inflexible?

Mr. SURREY. Well, I suppose it depends what kind of fiscal policy we have. In other words, we can have fiscal policies of varying degrees of flexibility. I do believe that it is possible, within our governmental structure, to develop a countercyclical approach that will be sufficiently prompt in its response to economic conditions, both in the timing of action and effect of action, to be a mitigating influence on economic fluctuations.

Representative GRIFFITHS. Well, do you think it is easier to do it taxwise? Do you think you can create a more flexible policy that way than you can by expenditures? Changing the rate of expenditure?

Mr. SURREY. Let me put it this way: You can't say that the country should put all its chips on one policy, rather than use any of the others. In other words, place all its chips on tax policy, or all its chips on monetary policy, or all its chips on expenditure policy.

By the same token, we can't just discard any one of these measures. Expenditure policy does seem to be rather difficult to operate in as flexible a fashion as tax policy could be. Expenditure programs are harder and sometimes very costly to turn off, and, on the downswing, require more time to activate.

On the whole I would say that tax policy can be more flexible than expenditure policy.

Representative GRIFFITHS. Expenditures are harder to turn off, and actually take longer, really, to start, and longer to get into the mainstream.

Mr. SURREY. That is right.

Representative GRIFFITHS. To what extent could the need for more flexible fiscal policy be reduced by better forecasting?

Mr. SURREY. I suppose in general the better the forecasting, the less need there is for flexibility. In other words, it may be that at times one could forecast changes that don't ultimately occur, and, therefore, start to make recommendations in tax policy, whereas if we had greater wisdom, the recommendations would not be made. The more we have the gift of prophecy, which forecasting is, I guess the better we could design and schedule tax measures in advance and would not be so dependent on speed.

On the other hand, despite the great improvements that we have had in forecasting, as I indicated in my statement, there are still great uncertainties and speed and flexibility will be important for a long time to come.

Representative GRIFFITHS. Do you think that one reason for a more flexible fiscal policy is that monetary policy operates only with long lags and uncertain effects?

Mr. SURREY. Yes, I think that may be one of the reasons for a flexible fiscal policy. I think another of the reasons would be also that monetary policy has its particular ways in which it operates. That is, it operates on certain sectors, and not on other sectors of the economy, and consequently, again to put all our weight on monetary policy would mean that our flexible policy is going to operate only through certain sectors of the economy.

Now whether that is fair or unfair depends on how broad these sectors are. They probably are not as broad as the sectors which would be affected by tax policy.

So I would say that we would need a flexible tax policy, both because monetary policy has its lags, and secondly, because it has its particular sectoral effects in the economy. Also, balance-of-payments considerations can affect the extent to which monetary policy can be used.

Representative GRIFFITHS. Well, do you think that the flexibility of fiscal policy depends more on the speed with which the decisions are made and implemented, or on the speed with which changes in taxes or expenditures take hold and affect private spending?

Mr. SURREY. Well, as my statement indicated, I would underscore speed, and speed involves a number of things—recognizing when the change should be made, enacting the change, getting the change on the books and operative, and then speed in the effects of the change being felt throughout the economy. I don't think one can say that speed is more important in one place or the other. Consequently, measures have to be chosen which lend themselves to speed in these various stages of the process.

Representative GRIFFITHS. I would like to ask you once you have decided to enact a tax to stop a boom, in place of enacting a small tax, why not really a whacking tax? I mean, really stop purchasing for a month or 2, or 3 months? I mean, a tax of such proportions that it will be felt immediately by every person.

Mr. SURREY. I think in some respects that resembles the suggestions of some that there be, say, a withholding holiday, or something of that nature.

Representative GRIFFITHS. Yes, when you have a depression, quit withholding, completely. But when you have inflation staring you in the face, really tax, pick up an awful lot of money, out of every check, every month, for maybe 3 or 4 months.

Mr. SURREY. Well, there are some technical aspects, and then, perhaps, some economic aspects.

Representative GRIFFITHS. Well, give us the technical aspects.

Mr. SURREY. One technical aspect is that if you were to have a withholding holiday for a month, and that would be a large amount of money, the extent to which people were affected would depend upon the extent to which their payroll periods fell within the given 30 days.

Now people get paid in all different ways. Some get paid weekly, some get paid every 2 weeks, some every 15 days, some every month, some every 30 days, and it would just depend where your payroll period came, in the 30 days, how much you got hit or benefited. It could have an erratic effect on individuals, and people in this plant would have a tax increase, and people in that plant would not, depending upon just how the plants had their payrolls handled. Tax holidays have a highly inequitable effect among individuals, and, therefore, are not as desirable as changes which are more spread out.

Now apart from that problem—and I think it is a big difficulty to surmount—the questions of how much effect you need and how much stimulus a restraint you would get in relation to the amount of tax change that would be involved are questions that would have to be considered. A short tax holiday implies that you know at the beginning just what is needed. With a smaller change more spread out you can keep it in effect until you see that you don't need it.

I think on the whole, people come to feel these effects probably should be spread out, rather than be concentrated in one short period.

Representative GRIFFITHS. Well, one of the things, as I think you may remember, I tried to find out, was: What were people willing to use the tax cut for? What were they going to spend it on? I thought about it for a long time. It seems to me that if it is a large tax cut, they buy larger items.

Mr. SURREY. Yes.

Representative GRIFFITHS. A small tax cut disappears. And I would think that a small increase is going to have the same type of effects but particularly where you have a constant employment. I would think that it is going to make the demand for credit much greater, if you have a tax increase.

I think you would feel it would be this way corporationwise, too. It has been argued by yourself that temporary stabilizing tax changes should not affect relative tax burdens while they are in effect, or overtime. That they should be neutral.

Now you have described neutrality to us. Do you think that short-run tax changes should bear more heavily on corporations or households, and investment or consumption from the standpoint of their effectivneess?

Mr. SURREY. I think that these short-run changes should have a bearing on both investment and consumption, but the greater effect should be on consumption, largely for the reason I indicated, that as far as economists know, the predictability of the effect of tax changes on consumption is much greater than that with respect to investment. The immediacy of the effect also is greater, so that consequently you are buying more effect with your tax change, to the extent it operates on consumption. You are getting more of the response you want in a quicker period of time, and for that reason, the changes, I think, should apply to a greater extent to consumption, but there should be application to both consumption and investment.

Representative GRIFFITHS. Do you think that household spending will be affected by temporary changes?

If they get to the place where they know this is going to happen all the time? Will it weaken the effect of the whole thing?

Mr. SURREY. Suppose I break it down this way: As far as I can gather, the economists do think that people respond to the temporary changes in pretty much the fashion they are going to respond to the long-run changes, taken in the aggregate. You can get into differences in individual response, but just talking in the aggregate, given a change over a period of a year or so, of a temporary tax increase or decrease, that change would affect people's spending patterns.

And consequently, and that is the reason essentially, why the individual income tax is useful.

Now as to how people would react to constant or, rather, frequent temporary changes, of course, I don't think we would have constant temporary changes, or even changes very frequently. The question is, however, if changes are expected what are the anticipation effects?

It would seem that people, expecting that there would be these stabilizing changes, might guide themselves accordingly and thus not anticipate booms and busts. This would have a moderating effect on the economy.

Representative GRIFFITHS. How much problem do you think it would cause in tax administration to increase taxes and decrease them in the same year?

Mr. SURREY. The immediate problems would be that for employers, which would come from changes in withholding rates. That is, they would have to change them one way, and then change them another way.

You would perhaps get a certain amount of annoyance during the year. It could be done. It would all end up as an annual rate in the individual's final tax return, and could be handled. If it had to be done, I think it could be done administratively.

Representative GRIFFITHS. You say:

On the other hand, evidence appears to indicate that the time lag between tax change and expenditure change are substantially less, and the effects are more certain for consumption than for investment.

What is the evidence?

Mr. SURREY. I think the evidence that economists have are results of changes in the past that have affected individuals, changes in taxes like the 1964 act, changes in individuals' income through changes in veterans' insurance programs and the like. These are the things to which economists have to go in order to determine the past patterns of individual response which can be compared with similar experience from things that affect business income. I gather the economists like variation in tax policy, or any other policy, since it gives them some events to look at to predict the effect of changes for the future.

Representative GRIFFITHS. What about the economists who have pointed out that the real boom now is in capital goods? We have created it by our tax reductions, and the way to shut it off is shut off some of the tax reductions? You would have an immediate effect. I don't buy the argument it is going to be slow. I think you would cancel orders immediately.

Mr. SURREY. Without going into the question of whether we do or don't now have a capital goods boom first, as to canceling orders, this cannot come until plans have been changed. Having started a new factory project to the point of starting to construct the building, you don't leave unfinished walls, or an empty building. So it takes a while to decide which orders to cancel. Another question is what is the impact of the cancellation of the order? A supplier may have a backlog of orders, so that some orders being canceled simply reduces his backlog. He is still producing for his current orders, so that the effects of the cancellation of the orders does take time to work itself through the economy.

Representative GRIFFITHS. Well, of course, I think the cancellation of a good deal of that backlog shuts it off right then. And I think it would shut it off right then.

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Mr. SURREY. Well, the question is when the effect would actually be upon, one might say, the operating of plants and so forth. If you cut off a backlog of orders here, and the plant is still working on all its current orders, the effect is going to be felt, but it is going to be felt a year or two in the future.

Representative GRIFFITHS. Quoting from your statement, you point out:

> If, after a year or so, the change is no longer needed, it should come off in the same way that it went on.

Do you suggest that it takes about a year to figure out what is going to happen from one of these tax changes, or do you think less than that?

Mr. SURREY. I wasn't intending to make a prediction there. I think some economists would say that the time period would be less than a year. I think, generally speaking, though, most of them would assume that temporary changes would be on for a year or so. The point I was trying to make here dealt with what it means to say that a change is temporary. I think it means that you will take the change off the way you put it on. That was the point I was trying to make, rather than emphasize the year or so.

Representative GRIFFITHS. I would like to ask you to comment on the suggestion that we put into affect a series of tax reductions in units, going over perhaps 5 or 6 years, with which we could either suspend or stimulate.

What do you think would be the problems with it?

Mr. SURREY. The problems I saw with that interesting suggestion that was made to your committee is that it is in a sense a commitment to a course of action, tax reduction over time. It was rather interesting that one witness said in effect that, over the next few years, we can expect an increase in revenues, because our revenues go up about $7 billion to $8 billion a year, and that this increase in revenue should all be dedicated to tax reduction. This would provide a bank of tax reduction, which we could reverse in any given year, if we wanted a flexible policy.

And another witness suggested that we commit ourselves over the next few years to expenditure increases, and that all this increase in revenues be committed to these expenditure increases, and then we would have a bank of expenditure programs that we could do with as we wanted to, flexibly.

Well, that seems to me is an indication that you can't commit yourself one way or another to either of these courses of action.

Representative GRIFFITHS. Well, forget about what you are going to do with the money, and expend it. The point is that if you passed a tax bill which included reductions, you would accomplish one thing. You would have speed with which to act. You would be able to act rapidly.

If you had the thing already in effect and, therefore, only suspended the tax decrease or increased the tax decrease, you would have accomplished one thing. You would have some, a much greater latitude of movement.

Mr. SURREY. I think that would presuppose that you have committed yourselves to a form of tax reduction, a constant, consistent pattern of tax reduction, year in and year out, over the long haul, it just seems to me impossible to say now what the structural pattern of reduction should be 4 or 5 years from now.

Representative GRIFFITHS. But isn't the whole problem right now the fact that if a tax increase or decrease is now suggested, you know as well as I that we are going to argue for weeks over who gets it—where the tax is increased, and who gets a decrease. That politically, you couldn't possibly increase it on individual accounts, and not on corporate accounts. No matter what you thought about it. You couldn't possibly do it.

Mr. SURREY. I would say that in a sense, these hearings, and I suppose any report that this committee makes, would tend to narrow the areas of—I don't want to say narrow the areas of disagreement. Let me put it that this committee will indicate the channel of agreement through which one should steer, if one is involved in a tax increase or tax decrease.

And I think the hearings that this committee is holding will indicate that there is a channel in which there is agreement and the waters are less troubled if you stay in this channel than they are outside of the channel. And your comment that you would need on an increase side, both increased taxes on individuals and corporations, I take as a very useful channel marker.

And to the extent you stay in that channel, a legislative measure would move much more rapidly.

Representative GRIFFITHS. Well, now, the practical problems of putting into effect either a tax increase or decrease, either to stimulate the economy or to deflate the economy, the first problem is to get people to agree that now is the time to act. That is the first problem. You are not going anyplace until that starts.

And at the present moment, in spite of the fact that I have been sitting on this committee, on the Ways and Means Committee, and I was sitting on Banking and Currency, when that Money and Credit Commission reported, and I well remember when Samuelson said that in 20 years, the President is going to have the power to reduce or increase taxes at will. And I think that was about 8 or 10 years ago, and it is not a bit closer today than it was then, so I don't think that is going to work out.

And the very first time it was ever suggested to me, I asked then, "If you can tell the President when to do it, why can't you tell Congress, and why can't we learn?"

Now you have all kinds of practical involvement right now. First, the President isn't convinced, obviously, that something has to be done as of this minute. Some Members of Congress think something should be done at once. Some think that we should delay. Some feel that we have already enacted such tax increases that they are going to have a very slowing effect, within a little while.

So that the problem is first of deciding when to do what, and secondly, who gets the tax increase or decrease. Unless you enact a bill that sets up tax decreases or increases over a long period of time, you are going to fight this battle out in every Congress. Should we act now? And if we should act, who should get hurt?

That is really the problem. Don't you think it is?

Mr. SURREY. I certainly couldn't disagree that there are problems associated with this. I would recognize with you that, as I have indicated, the feeling is that this is a matter which the Congress can handle. In other words, within its own process, it can act. And I would agree with that.

Representative GRIFFITHS. I do, too.

Mr. SURREY. I would agree that there may at times be great uncertainty as to whether we should act. With the uncertainty it would be hard to get quick congressional action, so that the uncertainty can result in inaction. But this is not so bad or fatal. The very uncertainty itself as to whether action should be taken indicates that inaction will not be fatal, so that this problem doesn't seem to me so great.

It is difficult to recognize when an economy is changing. But when the signs are clear, there is still time to act, if there can be agreement on the course of action.

Representative GRIFFITHS. On what to do.

Mr. SURREY. And that takes us back again, I think, to the question of agreement on the course of action. Now that can change with time. I can't see people today laying down a course of action for all time, as to what is the best flexible change. But I do think that the hearings before you have shown a reasonable amount of consensus, as you have indicated. If the need for a tax change were clearly recognized—and I make that as a condition along with you—it is not so difficult to come to a decision that such-and-such temporary change is a fair change.

You, yourself, have indicated certain benchmarks, and I am sure this committee will indicate other benchmarks in its report. It will indicate some matters that lie outside, as I say, a consensus, and some matters that lie inside.

Congress has acted with remarkable speed, when it has felt that the recommendation is comfortably within the area of general agreement. It seems to me that it certainly should be possible for people to devise a program that is within the area of general agreement. So I would not be pessimistic.

Representative GRIFFITHS. Well, I think it is essential that we have that, and that, of course, is what we are really struggling to do on this committee, but I think that you can't ignore the fact that we have to have more understanding of when to act, and we have to agree on what to do, and we are, in all of this, of course, every Congressman looks at this also from a political viewpoint. And while I don't agree with the fact that politically, you get hurt by this sort of thing, nevertheless, there are a good many people who would think of it from this standpoint.

I would like to ask you one other question. One of the things, as I recall, that Mr. Heller pointed out, when we first began talking about tax cuts, was that the problem was that you would have a tremendous amount of money in the budget for which you had no use if everybody were employed at paying taxes at the rates at which we orginally had them set.

Now I am beginning to wonder if we now consider a tax increase, when you still have more than 2 percent of the people unemployed, what happened to that theory?

Mr. SURREY. Well, you are getting me, I think, into current conditions.

Representative GRIFFITHS. No; I don't really want to do that. What I want to say to you, what I want to ask you, is this: Do you believe that it is as clear now as we once believed it to be, that with full employment, you wouldn't have a tax increase?

Mr. SURREY. Would not have a tax increase?

Representative GRIFFITHS. Yes. In theory, with full employment, you were going to have tax decreases, weren't you, from the rates we had?

Mr. SURREY. Yes. In theory.

Representative GRIFFITHS. In theory, we were going to have tax decreases.

Mr. SURREY. We have a certain amount of increased revenue each year with an economy that is growing, and the revenue has to be utilized in some fashion through tax reduction, or payment of the debt, or increased expenditures.

Representative GRIFFITHS. Yes.

Mr. SURREY. I would, in passing, say that I think the economists have their problems as they frankly acknowledge in prescribing for a full employment economy. It is much easier to recognize when unemployment is high what to do about the matter. I would suppose most discussions of tax flexibility in the past have centered more on recessionary situations than on inflationary situations, because as you say, it normally should be rather difficult to work yourself into an inflationary situation.

There are times, though, when the full employment economy can be affected by things that cut sharply across, like a war, or other matters. This creates problems that are not within the normal context, I think, of the conditions that Professor Heller was discussing. I would agree with you.

Representative GRIFFITHS. Well, anyhow, no matter what his theory was, it worked out fine, I thought. Whether the theory was right or not, the whole effect was great, and I am sure we all enjoyed it, but now we are going to be stuck with a new problem, and we are going to have to invent a new theory, I think.

Mr. SURREY. We have our problems now. In the long run, we will be back to the question of what to do with our fiscal drag.

Representative GRIFFITHS. Thank you very much for being here, Mr. Surrey. You were very kind, and you were very helpful, as you are always helpful.

Mr. SURREY. Thank you.

Representative GRIFFITHS. This completes the hearings. Additional statements from Representative Hanna, of California, Senator Saltonstall of Massachusetts, Representative Todd of California, and Dr. Keyserling will be included at this point. Further statements and materials received for the record will be included in the appendix.

(Whereupon, at 11:20 a.m. the subcommittee adjourned.)

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., April 1, 1966.

HON. MARTHA W. GRIFFITHS,
Chairman, Subcommittee on Fiscal Policy,
Joint Economic Committee.

DEAR COLLEAGUE: Thank you for your letter of March 15, 1966, concerning your hearings on changing taxes promptly for purposes of economic stabilization.

I am attaching, for your interest and information, a copy of a recent statement of mine.

Yours sincerely,

RICHARD T. HANNA,
U.S. Congressman.

Statement Submitted by Hon. Richard T. Hanna, a Representative From California

PROBLEMS OF ECONOMIC POLICY

Commercial loans increase the overheating of the economy. There are ample signs and signals to demonstrate this fact.

New plant investment, which was up last year, is projected for an even greater increase this year; up over 8 billion, which indicates an increase of over 10 percent of our gross national product. For 1966, there will be 80-plus billion in new plant expansion. Why does the first increase in interest rate fail to touch it? There are two very good reasons, both of them tax oriented.

First, a tax incentive credit of 7 percent which is well above the interest rise effect.

Second, the Internal Revenue Service ruling of March 1965, allowing full deduction on Federal income tax returns for all loan reserves. This encourages banks to double 1965 commercial loan rates.

It is, therefore, evident that a further increase would only result in its being eventually nullified. Please, Mr. Martin, do not give us any more of your "interest increase meat-tax surgery." Our need is for more selective and precise instruments to do the delicate balancing operation.

May we suggest to the Congress the following: First, decrease the investment tax credit to where it matches a prime interest rate, say, to 5½ percent; second, create a tax increase standby of 1 percent income tax and 2 percent corporate tax.

May we also suggest to the Federal Reserve the following: Decrease the money supply by requiring greater reserves from banks. This action will cause banks to use their available money to purchase Federal Reserve notes to soak up available surplus cash which is now going out in commercial loans.

As we have urged for an increase in money supply for expansion, it is only reasonable that we should call for a decrease to apply the appropriate "braking" action.

Statement of Hon. Leverett Saltonstall, a U.S. Senator From Massachusetts

I feel very strongly that the Congress should retain control over the tax policy of the Nation, for we have shown that we can act swiftly if an emergency calls for it. I do not believe that this is a power that should be delegated as some have suggested.

On the other hand, I feel that Congress should make every effort to weigh all expenditures most carefully during the period of increased defense needs. We see many of our domestic programs expanding rapidly, some of them so much so that administrative problems have developed in many of the newer areas of Federal activity: education, the war on poverty, urban development, conservation, and others. We see a great need for a concerted approach to the Nation's problems. Brought on by increasing population and higher technical requirements for industrial training, as well as the growing needs of world population, we must see these needs related to our other activities of government. Perhaps some of our older programs should be viewed with a new skepticism and some of the new ones developed at a rate which will allow more careful administration. Local and State governments must be given a greater opportunity to take part and to provide their own financing.

These are areas with which I have been concerned for the last few years and on which I have worked very hard in the Appropriations Committee. I hope very much that if your subcommittee studies tax problems you will have an opportunity to relate our taxes to our Government expenditures to keep both under close governmental supervision.

Statement of Hon. Paul H. Todd, Jr., a Representative From California

There is no need here to recite again the facts behind our present concern about inflationary pressures in our economy. Clearly, pressures exist; just as clearly, they are increasing. Informed and prompt action is called for, and I would like to congratulate the joint committee for providing a much-needed forum in which facts and suggestions to this end can be fully heard.

One general point should be made about our present economic situation. It seems clear that our major policy goal for the past 6 years—to get the economy moving again—has been successfully attained. We have a rapidly growing, full employment economy. Indeed, our success has produced new and difficult problems. For the problems of the past—unemployment, deficiency of demand, underproduction, and so forth—have been superceded by the problems of the present—price stability, sectoral labor shortages and undercapacity, localized excess demand, and so forth. And, just as the problems of the present are distinct from the problems of the past, the techniques used in solving the problems of the past are not necessarily the techniques appropriate to coping with the problems of the present.

For example, one of the problems of the decade of the 1950's was an overall insufficiency of demand, resulting in unemployment and underutilization of resources. The Kennedy administration, and the Johnson administration following, took steps to increase aggregate demand: The 7-percent investment tax credit, tax cuts, stepped up depreciation allowances, and so on. These were aggregate measures, designed to affect aggregate demand. However, I have serious reservations whether such aggregate measures are still fully appropriate to the problems we face in a full employment economy. These are new problems and they may require new solutions.

For example, I am not sure whether the inflationary pressures we are presently experiencing are the result of an overall excess of aggregate demand. For example, localized conditions of excess demand can cause price increases which then spread to other sectors, causing "creeping inflation" without any overall excess of demand. (For a more detailed statement of this argument, see my remarks on the floor of the House on Friday, October 22, 1965, and the very important paper by Charles L. Schultze, "Recent Inflation in the United States.") In such cases, policy measures designed to cope with overall excess demand would not really get to the heart of the problem.

Monetary policy is, by and large, too undiscriminating in its effects and requires too long a lag to take effect. Fiscal policy is more precise, but it often is unnecessarily delayed in becoming law; for this reason I welcome the preliminary hearings conducted by the joint committee, just as I welcome the standby legislation suggestions offered in the majority report. More precise tools—such as the Federal Reserve Board's Regulation W, limiting terms of consumer credit, or the measures contained in the Defense Production Act—are at present lacking.

It would seem that policies designed to maintain a full employment economy with stable prices ought to have two main characteristics. First, they should be sufficiently precise that they would affect those key areas of inflationary pressure without having an adverse effect on other sectors of the economy. Measures to introduce excise taxes on certain commodities, such as copper, in scarce supply would have a useful effect on underlying demand conditions. Measures to adjust terms of consumer credit might be effective in regulating demand for durable goods. Administrative measures to loosen up inelasticities in labor supply and mobility should be considered. In all these cases, and in others, consideration should be directed precisely to specific sectors of the economy, rather than relying on overall measures.

Second, policies to maintain full employment and price stability should be flexible enough to allow them to change when economic conditions change. That is, policies adopted should be easily reversible. It would be pointless and shortsighted to pass a measure to decrease aggregate demand without making sure the measure permitted an increase in demand at such times as it appeared warranted. For this reason, I welcome the suggestion of the committee that the repeal of the 7-percent investment credit provision should be accompanied by a provision that the credit would go back into effect at a fixed future date unless the Congress acts to extend the suspension.

It seems to me that the most serious consideration should be given to repealing the 7-percent investment credit. Investment usually leads further economic expansion and presages increases in demand; investment has an unusually high multiplyer effect within the economy; investment has risen unexpectedly rapidly in the past few months, and there is no reason to expect it to decline without external pressures being applied. Uninterrupted high levels of investment could lead to a general inflation. I concur with the recommendation of the joint committee that the 7-percent credit provision be repealed, with an ironclad guarantee to restore it when the economy shows signs that it needs further stimulus. I do so in the full realization that tax increases in an election year are often said to be politically dangerous. However, I believe the American public is wise enough to realize the values of prudence over expediency and to understand that a small tax increase now is by far preferable to a general and disastrous inflation later.

One further suggestion might be usefully considered. One of the continuing problems of our economy has been the difficulty small businesses face in obtaining investment capital. Large companies, generally, can get just about as much investment capital as they need for new plants and equipment. They are big enough to finance their own expansion out of current earnings or to get loans at low-interest rates. Studies suggest that large companies expand when they judge a profitable market exists, and that they do not pay much attention to prevailing interest rates.

But small businesses are in quite a different situation. Faced with a small capital and earnings base, the small businessman wishing to expand has usually found himself having to pay dearly. He is not big enough to command a low interest rate from the banks, nor does he have sufficient profits to finance growth out of retained earnings. In our present situation, with the money market tighter than ever, the small businessman clearly faces a difficult situation.

These facts lead me to suggest that study be given to repealing the investment tax credit on a graduated scale designed to help small businesses. Large corporations employing, for example, over 1,000 people, would find the 7 percent investment credit entirely repealed. It is such corporations which do the major part of the investment in our economy, and it is the major part of investment that we want to reduce to stop inflation. Companies employing from 501 to 1,000 workers would receive only 3 percent investment credit; companies employing from 101 to 500 workers would receive 5 percent credit. And the very small businesses, employing 1 to 100 workers would retain the full 7 percent tax credit.

Large corporations, which are making the highest profits in history, would be able to afford a cutback on investment, thus contributing to the antiinflation drive; small companies, which contribute a small percentage of the economy's total investment, would still have the incentive to invest, modernize, and grow. I believe this suggestion introduces a degree of flexibility much needed in our fiscal policy, while at the same time contributing an administratively feasible way to fight inflation.

Statement of Leon H. Keyserling,[1] President, Conference on Economic Progress

I appreciate this opportunity to furnish a statement with respect to changes in national tax policies, which I suggest as needed immediately or in the very near future.

Let me begin by commenting upon some preliminary issues:

(1) I believe that a long-range national economic policy, designed affirmatively to optimize economic growth and meet the great priorities of our national needs, is more important and useful than short-range national economic policies designed to counteract difficulties arising in the absence of an adequate long-range national economic policy. I believe that this is especially true of tax policy. I believe that the tax reductions of 1962–65 were not as successful as they might have been in short-range terms, and that they leave us with a situation

[1] Former Chairman, Council of Economic Advisers. Consulting economist and attorney; president, Conference on Economic Progress.

calling for correctives now, just because they were not founded on adequate long-range analysis and objectives. Correspondingly, I do not believe that we need tax changes immediately to deal with any short-range emergency situation—such as the threat of dangerous general inflation, which I do not believe exists. But we do need immediate tax changes to restore an economically more sound and socially more just Federal fiscal policy than we now have. These points will be developed in more detail below.

(2) No important tax changes can or should be "neutral." Every important tax policy affects the allocation of resources and the allocation of national income, for better or for worse. To argue otherwise is, in my view, mere pretense. These allocations are at the heart of the whole economic problem. And the nature of these allocations go to the heart of our ultimate moral and social values as a nation and a people. These values should be the animating force underlying all economic policy in an economy as rich and productive as ours, under our free institutions and concepts of equal opportunity, social justice, and the dignity and worth of the individual. These values are at the heart of the whole war against poverty, at the heart of the Great Society itself.

(3) The technical design of the tax system cannot be separated from consideration of the foregoing fundamental objectives we hold as a nation and a people.

Having made these three preliminary comments, I turn now to the substance of my analyses and recommendations.

We cannot now make the needed changes in tax policies, if we assume in toto that the tax decisions from 1962 to date have been as wise and beneficial as proponents and propaganda claim. For if we make this assumption, and adopt the view that tax changes are required now only because the economic situation has changed, we will not correctly appraise what is wrong in the current situation, and we will lean excessively for guidance upon the economic analysis and social policy which have brought us to the difficulties we must now correct.

My repeated criticisms of the tax reductions and concessions, 1962–65, took three main forms, and I submit that these criticisms have now been validated by the most recent developments.

My first criticism was that the tax reductions did not recognize that the low rate of economic growth and the excessive levels of unemployment were due to a tendency of investment in the means of production to outrun demand for ultimate products in the form of private consumer expenditures and public outlays combined. I therefore challenged the desirability of tax reductions which allocated so large a part of the total to investment. I admitted that this would stimulate the economy for a while, but I said that $19–$20 billion a year thrown into the streets (the approximate annual value of the tax reductions 1962–65) would also have stimulated the economy for a while. However, I pointed out that the misallocation of the tax reductions would aggravate the disequilibrium in the long run, by creating an inordinate and nonsustainable investment boom.

I further said that a substantial part of the excessive tax reductions granted for investment-stimulation purposes would be wasted, in that there were already more than ample funds for these purposes, and that substantial portions of the tax reductions granted for these purposes would go overseas to aggravate our balance-of-payments problem, or be used at home for the noneconomical purpose of bidding up the stock market excessively.

In support of this entire thesis, I brought forward from time to time my charts 1, 2, and 3, designed to depict the nature of the economic disequilibrium. In view of this empirical evidence, I could not accept the validity of tax reductions of a composition indicated on chart 4, which shows in my view that far too large a part of the tax cuts were allocated to investment, and far too small a part to consumption.

At long last in 1966, although what is clear now has been clear for several years as I see it, the Council of Economic Advisers and others are recognizing that the investment boom has gotten out of hand, relative to the economy as a whole. This is clearly shown by my charts 5 and 6.

My second basic objection to the tax policies of recent years was that they were on net balance regressive. I do not believe that a regressive tax policy is most conducive to sustained growth and employment in an economy where investment tends to outrun consumption. I do not believe that a regressive tax policy comports with social justice in a society determined to make war against poverty, when we now have a pattern of income distribution as unsatisfactory as that indicated by my chart 7.

And I held that the pattern of the personal income tax cuts enacted in 1964 tended to be regressive for two reasons. My first reason was the pattern of the tax cuts themselves, in their impact upon disposable incomes at various income levels, as indicated by my chart 8. And my second reason was that the lesser reliance upon the Federal income tax, in view of its relative progressivity, intensified the horribly regressive nature of our nationwide tax structure as a whole. How horribly regressive this nationwide tax structure is can be demonstrated by looking at my chart 9, embodying a study as of 1960, and our nationwide tax system is far more regressive now than in 1960, not only because of the changes in the Federal income tax structure referred to above, but also because of the great increase in regressive State and local taxes, such as property and sales taxes, in recent years.

My third and perhaps most important objection to the tax policies of 1962–65 was that, even if not as vulnerable as I think they were from the viewpoint of economic equilibrium in the long run, they completely overlooked the real purpose of the Federal budget. The real purpose of the Federal budget is not to afford us the opportunity to increase taxes when the economy is moving too fast, and to reduce taxes when the economy is moving too slowly. The real purpose of the Federal budget is to use the spending power to allocate sufficient portions of our total national product and resources to the great priorities of our domestic and international needs which cannot be served by private spending.

Even if the tax cuts produced a sufficient increase in production and employment—which they did not—they tended to stimulate more and more production of relatively less vital goods and services, not to stimulate production of the goods and services in the public sector which are at the heart of the aspirations of a Great Society. I warned that the size of the tax reductions would make it harder for us to do in ample amounts the things we most need to do: rehouse our slum dwellers, rebuild our cities, cleanse our air and waters, provide ample educational and health services to all of our people at costs within their means, expand our miserably inadequate social security and welfare systems, lift our substandard wages adequately, develop and replenish our natural resources at an adequate pace, make a full-scale attack upon poverty, and so forth.

All this, too, has come to pass. Despite increasing defense outlays, the spending side of the Federal budget, as our greatest single instrument for vindicating the great priorities of our national needs, is estimated at only 15.05 percent of total national production for fiscal 1967; it was 17.71 percent in fiscal 1947; 17.01 percent in fiscal 1955; 16.09 percent in fiscal 1961; and 15.20 percent in fiscal 1966. Domestic priority programs are being slashed, delayed, and in no instance proceeding at an adequate pace.

We are now in the curious national state of mind where we are willing, if need be, to cut back on nonessentials if this should become necessary because of the pressures generated by increased expenditures for the Vietnam war. But we are not even talking about raising taxes to cut back on nonessentials, if this should be necessary to prevent dangerous retardation of the domestic priority programs of a Great Society. This bespeaks a moral unawareness, and, if it persists, this leaves no guidelines for the fiscal policies of a great nation and a great people.

I therefore suggest that we should embark immediately upon changes in national tax policies to improve the economic equilibrium, to reverse the dangerously regressive trend in our nationwide system of taxation, and to provide the sinews for carrying forward the great domestic priorities of a Great Society. To indicate the scope of the latter, and how they can be fitted without strain into the productive potentials of the U.S. economy in the years ahead, if we put first things first, I call attention to my charts 10, 11, and 12.

With these considerations in mind, I suggest these changes in tax policies, in the following order:

(1) Actions should be taken at once to withdraw the tax concessions to investors granted in 1962 and 1965. Action might simultaneously be taken to cancel out the corporate tax cuts of 1964, or alternately to impose an excess profits tax of about the same revenue value, which would probably be more equitable. These actions would increase Federal tax revenues somewhere in the neighborhood of $5 billion annually. They would be aimed selectively against the selective type of inflation now confronting us—the inordinate investment boom. They would leave ample funds available for any sensible levels of investment.

(2) These recoupments of Federal tax revenues should not be used to reduce the deficit, because the economy as a whole is confronted not

with great inflationary dangers, but rather with sizable likelihood within a year or so of insufficient economic growth to restore and maintain full employment. Unemployment and other unused productive resources are still far too high. The recouped Federal revenues in the neighborhood of $5 billion annually should be spent by the Federal Government toward meeting the great priorities of our domestic needs. This would also have the advantage of improving income distribution, and thus unite economic gains with social progress. It would also be anti-inflationary in the longer run, by reducing serious shortages in some areas of goods and services; for example, medical care and housing.

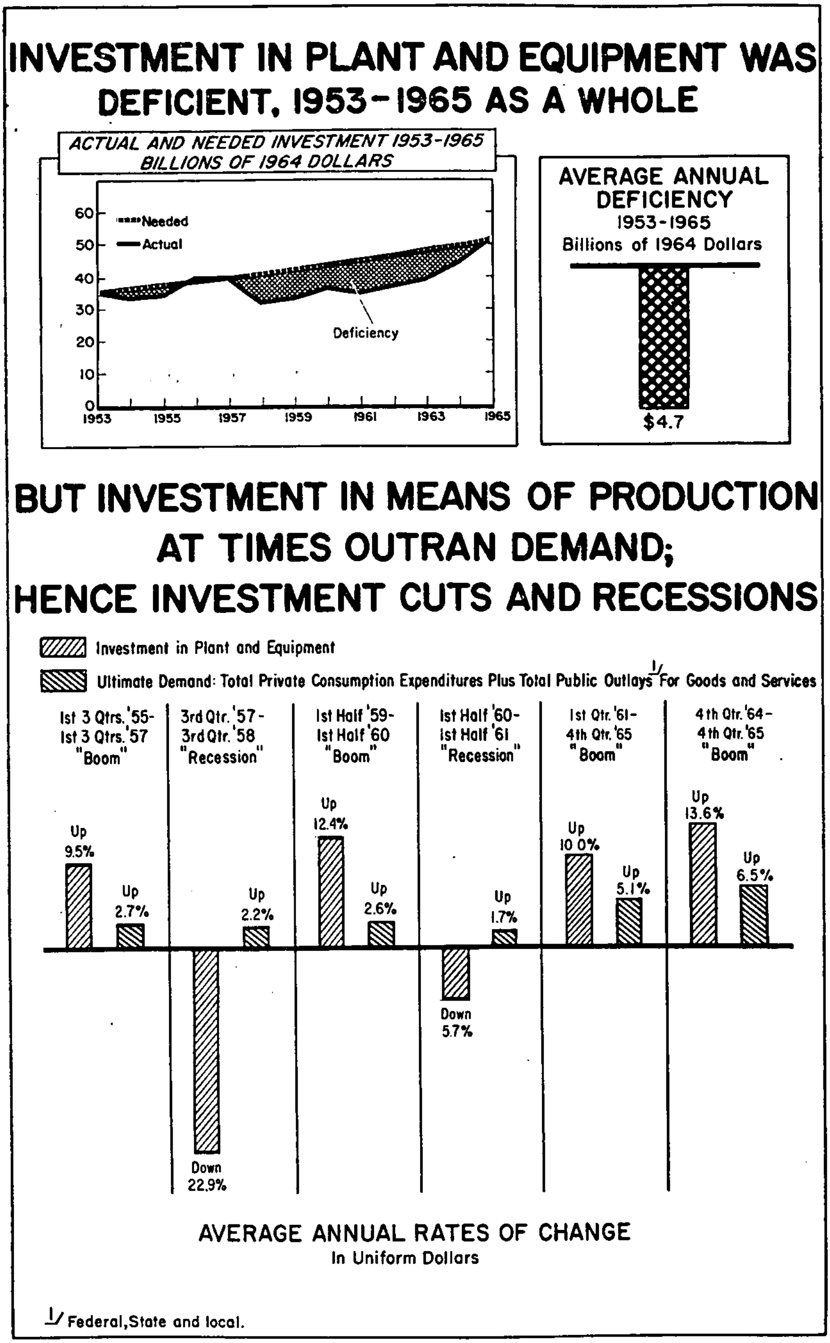
(3) It is arguable that even larger Federal revenue recoupments should be sought, if we are to carry forward adequately our great public priorities as a nation and a people. Or it might turn out that the program set forth above, especially if the international situation calls for still higher outlays than are now contemplated, might generate real and generalized inflationary pressures. In that event, although I do not recommend it for now, the next step on the tax front would be to increase some of the tax rates applicable to the upper half of the income structure, particularly in that this sector received too much tax reduction in 1964 and 1965, in view of the fact that most of the reforms which were designed to compensate for some of the tax reductions received were not enacted.

(4) In view of the regressive nature of the nationwide tax system, the amount of poverty and deprivation in the country, and general considerations of equity and social purpose, it would be unconscionable, under any foreseeable circumstances, to increase the taxes of those in the lower half of the income structure. Proposals for a flat percentage increase across the board are, in my view, without economic merit and without social conscience.

(5) In a well-designed reformulation of our fiscal policies, both on the spending side and the tax side, I believe that we should actually consider some further amelioration of the tax burden upon those low in the income structure. The need for a further lifting of the exemptions is long overdue. The negative income tax or its equivalent should receive serious consideration.

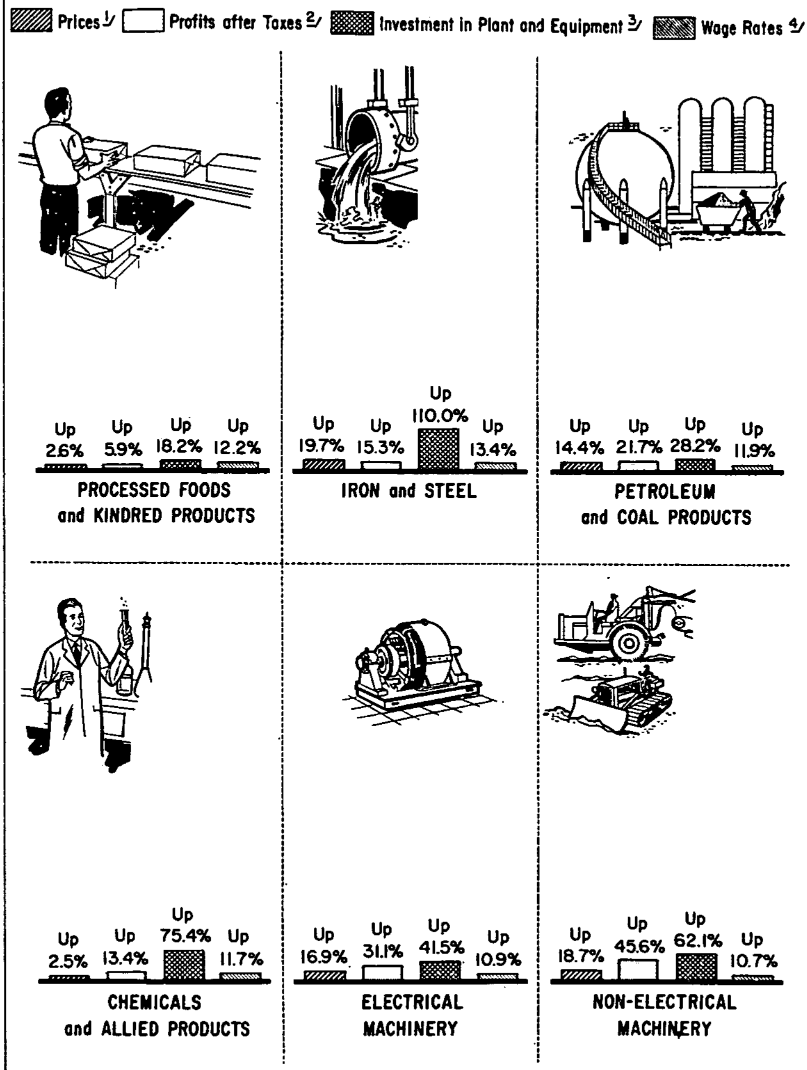
I hope that the time has come when the pretentiousness of technicians, the pious declarations of self-styled objective—that is, amoral—economists, and the overemphasis upon the aggregates of fiscal policy without regard for the components which ultimately affect the people of the country and in large part determine how they live, will no longer serve as impediments to a fiscal policy worthy of a Great Society.

I hope, also, that realization will grow that it is none too early to develop a national fiscal policy in a long-range perspective. If we take care of tomorrow, today will take care of itself. We have had too much of ad hoc improvisation. In the name of being timely, we have only been shortsighted.


INVESTMENT IN PLANT AND EQUIPMENT WAS DEFICIENT, 1953-1965 AS A WHOLE
ACTUAL AND NEEDED INVESTMENT 1953-1965
BILLIONS OF 1964 DOLLARS
Needed
Actual
Deficiency
60
50
40
30
20
10
0
1953
1955
1957
1959
1961
1963
1965
AVERAGE ANNUAL DEFICIENCY
1953-1965
Billions of 1964 Dollars
$4.7
BUT INVESTMENT IN MEANS OF PRODUCTION AT TIMES OUTRAN DEMAND; HENCE INVESTMENT CUTS AND RECESSIONS
Investment in Plant and Equipment
Ultimate Demand: Total Private Consumption Expenditures Plus Total Public Outlays 1/ For Goods and Services
1st 3 Qtrs.'55-
1st 3 Qtrs.'57
"Boom"
3rd Qtr.'57-
3rd Qtr.'58
"Recession"
1st Half '59-
1st Half '60
"Boom"
1st Half '60-
1st Half '61
"Recession"
1st Qtr.'61-
4th Qtr.'65
"Boom"
4th Qtr.'64-
4th Qtr.'65
"Boom"
Up 9.5%
Up 2.7%
Down 22.9%
Up 2.2%
Up 12.4%
Up 2.6%
Down 5.7%
Up 1.7%
Up 10.0%
Up 5.1%
Up 13.6%
Up 6.5%
AVERAGE ANNUAL RATES OF CHANGE
In Uniform Dollars
1/ Federal, State and local.

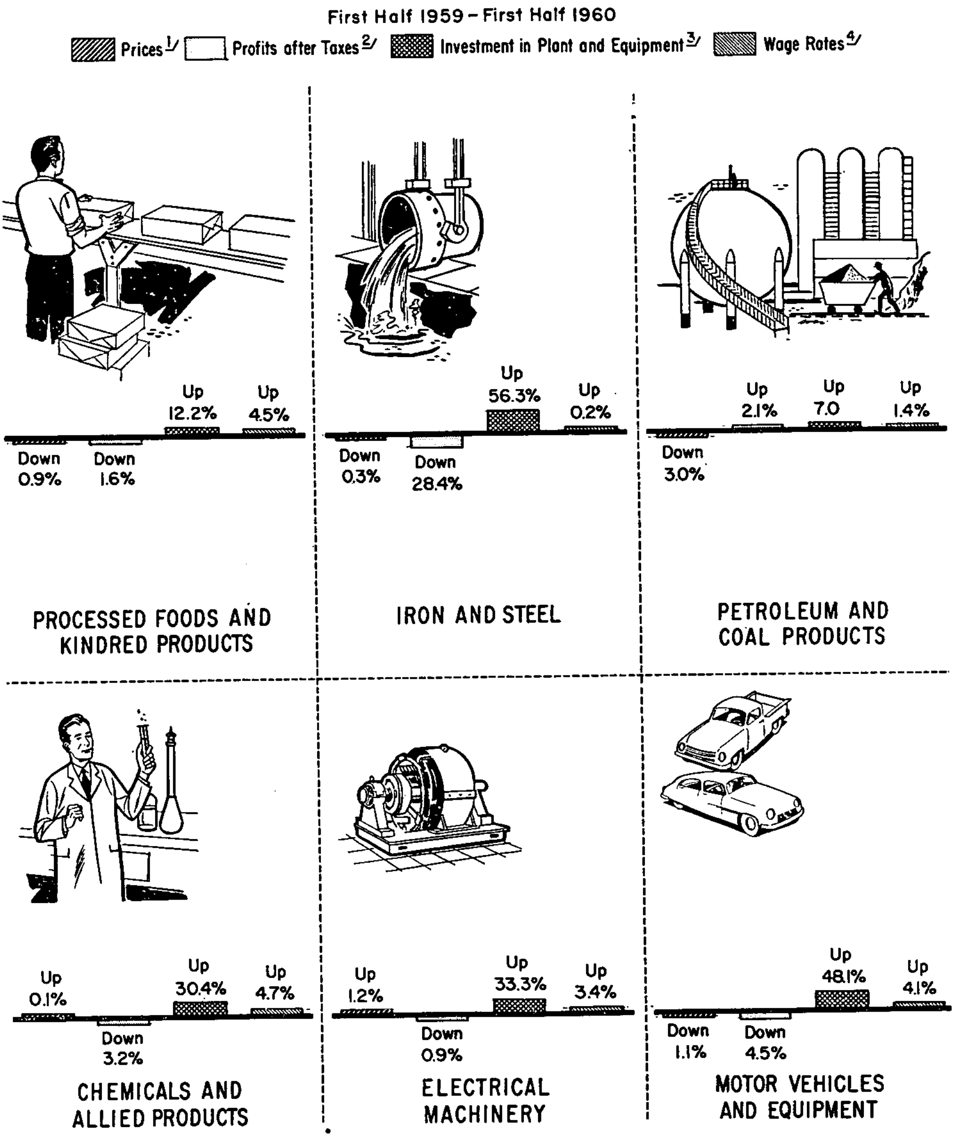
PRICES, PROFITS, INVESTMENT AND WAGES BEFORE THE 1957-1958 RECESSION

1st 3 Quarters 1955 – 1st 3 Quarters 1957



1/ U.S. Dept. of Labor, Bureau of Labor Statistics, commodity wholesale price indexes
2/ Federal Trade Commission – Securities and Exchange Commission
3/ U.S. Dept. of Commerce and Securities and Exchange Commission
4/ U.S. Dept. of Labor, Bureau of Labor Statistics, Average hourly earnings of production workers.

PRICES, PROFITS, INVESTMENT, AND WAGES BEFORE THE 1960-1961 RECESSION



1/ U.S. Dept. of Labor, Bureau of Labor Statistics, commodity wholesale price indexes

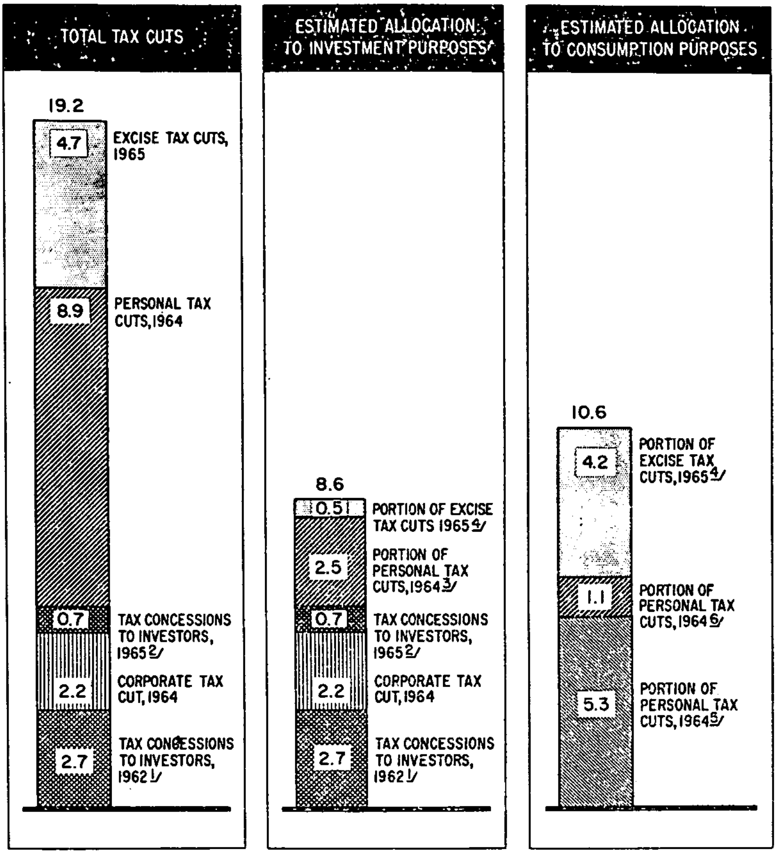
2/ Federal Trade Commission–Securities and Exchange Commission

3/ U.S. Dept. of Commerce and Securities and Exchange Commission

4/ U.S. Dept. of Labor, Bureau of Labor Statistics, Average hourly earnings of production workers.

ALLOCATION OF TAX CUTS 1962-1965: INVESTMENT AND CONSUMPTION PURPOSES

(Billions of Dollars)



1/ Through Congressional & Executive Action

2/ Through Executive Action

3/ Estimated portion of personal tax cut, for those with incomes of $10,000 and over, which they would save for investment purposes.

4/ Based on estimates of excise tax cuts passed on to consumers through price cuts.

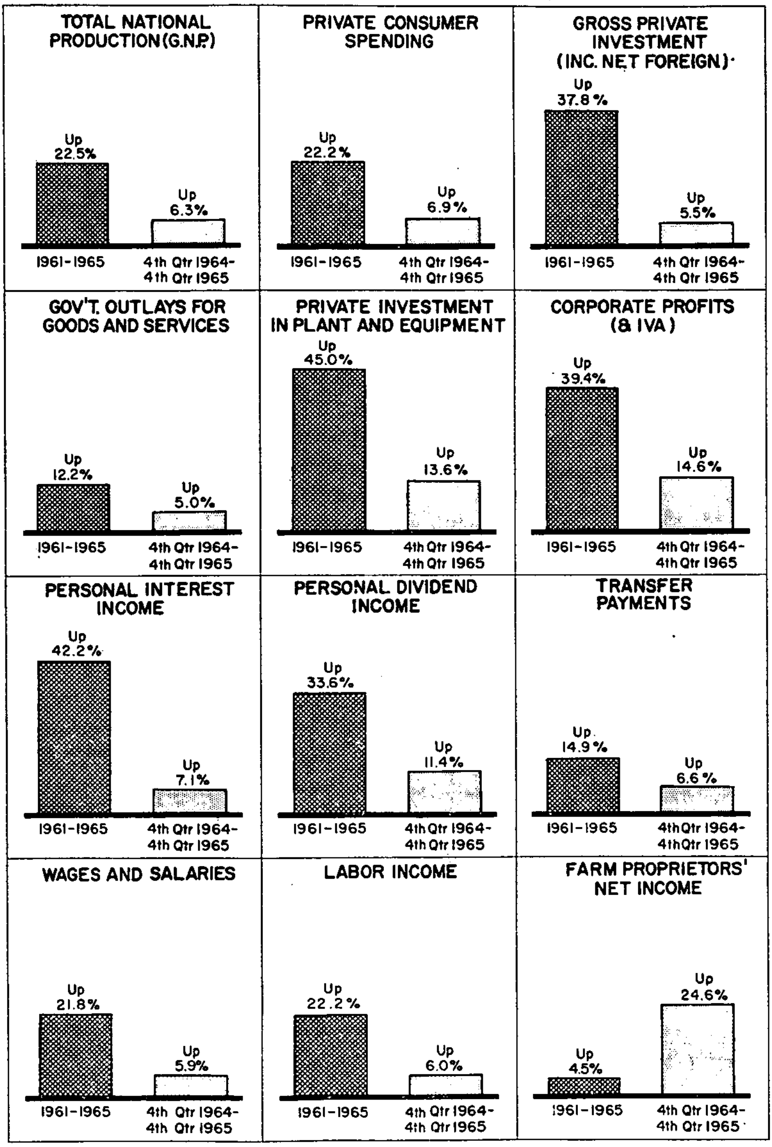
5/ Personal tax cuts for those with incomes under $10,000.

6/ Estimated portion of personal tax cuts for those with incomes of $10,000 and over, which they would spend for consumption.

Note: Estimates of excise tax reduction allocation by C.E.P. (amount might be passed on to consumers by price reductions) However, a large portion of this did not go to low income consumers.

COMPARATIVE GROWTH IN VARIOUS ASPECTS OF U.S ECONOMY 1961-1965

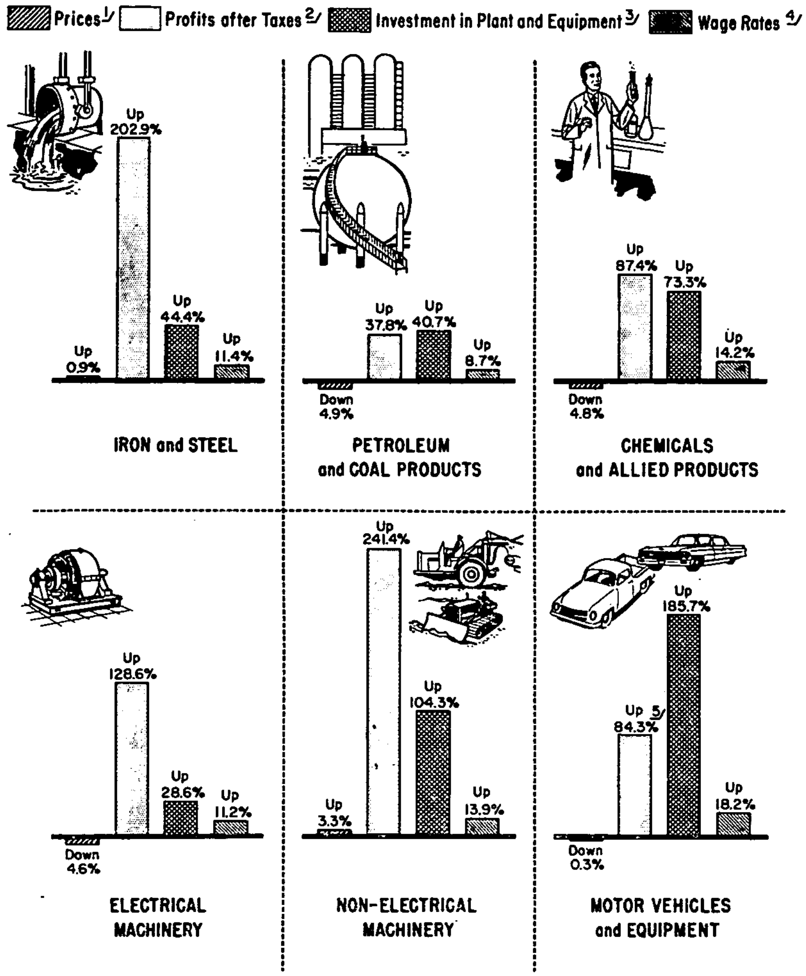
(Uniform Dollars)



Source: Dept. of Commerce, Office of Business Economics and CEP.

PRICE, PROFIT, INVESTMENT, AND WAGE TRENDS DURING CURRENT ECONOMIC UPTURN

Annual Rates 1st Quarter 1961–3rd Quarter 1965



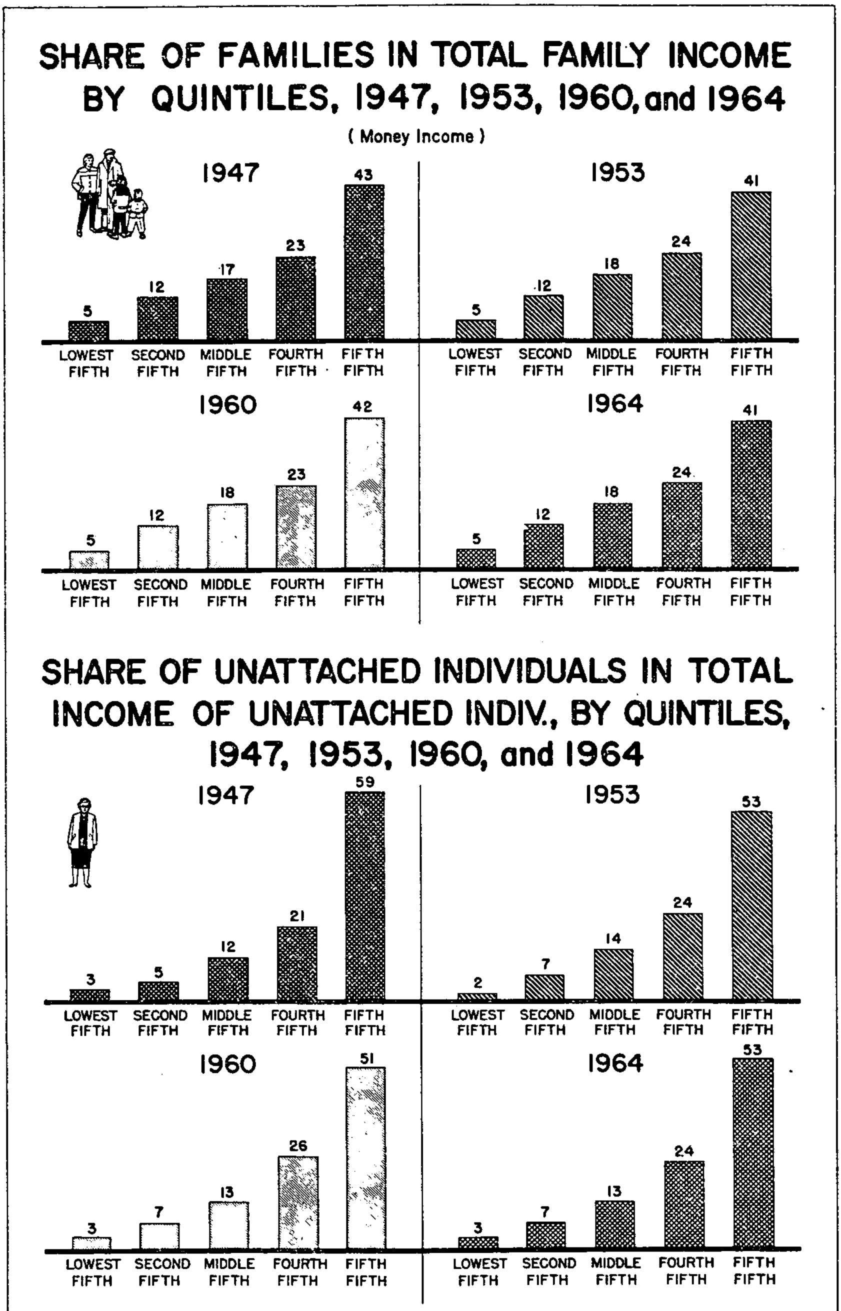
1/ Data: U.S. Dept. of Labor, wholesale commodity price indexes.

2/ Data: Federal Trade Commission–Securities and Exchange Commission.

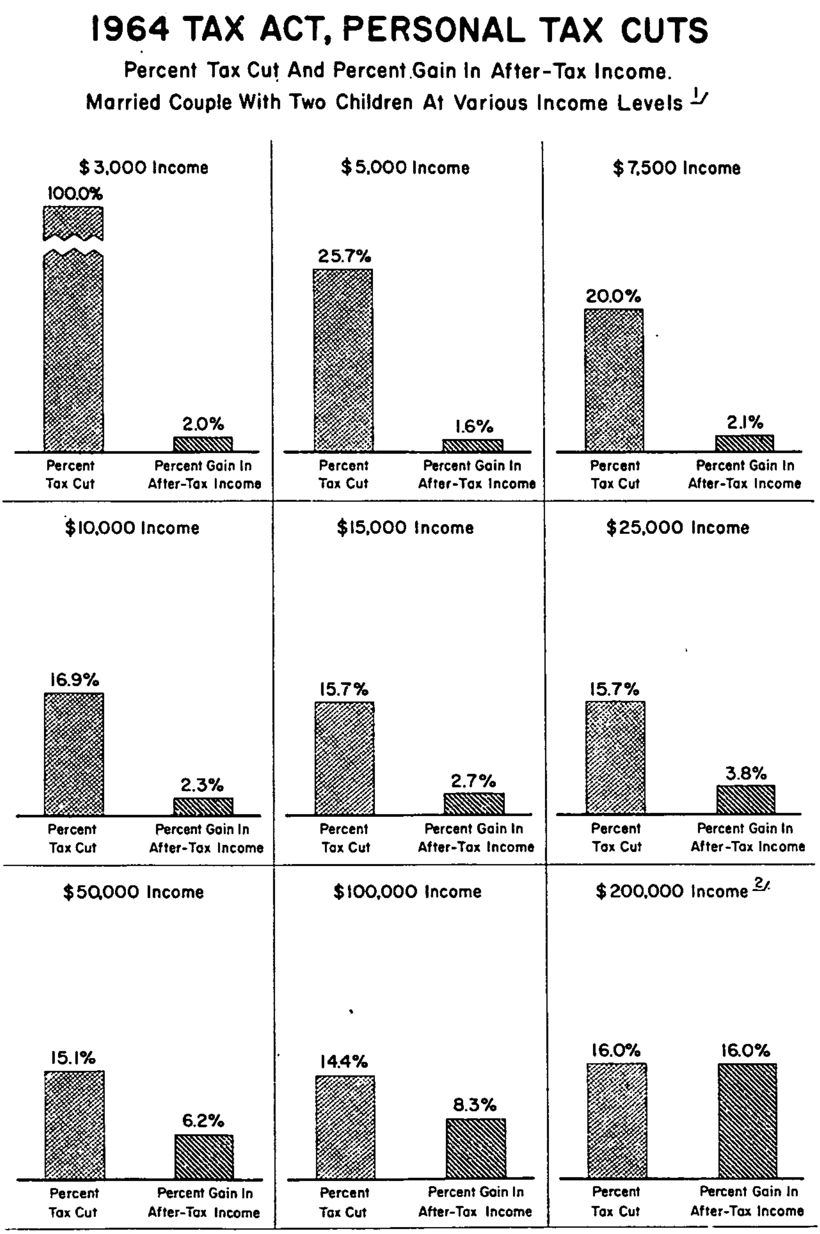
3/ Data: U.S. Dept. of Commerce and Securities and Exchange Commission; seasonally adjusted.

4/ Data: U.S. Dept. of Labor, Bureau of Labor Statistics; Average hourly earnings of production workers.

5/ Seasonally low due to vacation and model change over; the increase from 1st Q. 1961 to 2nd Q. 1965 was 316.1%.



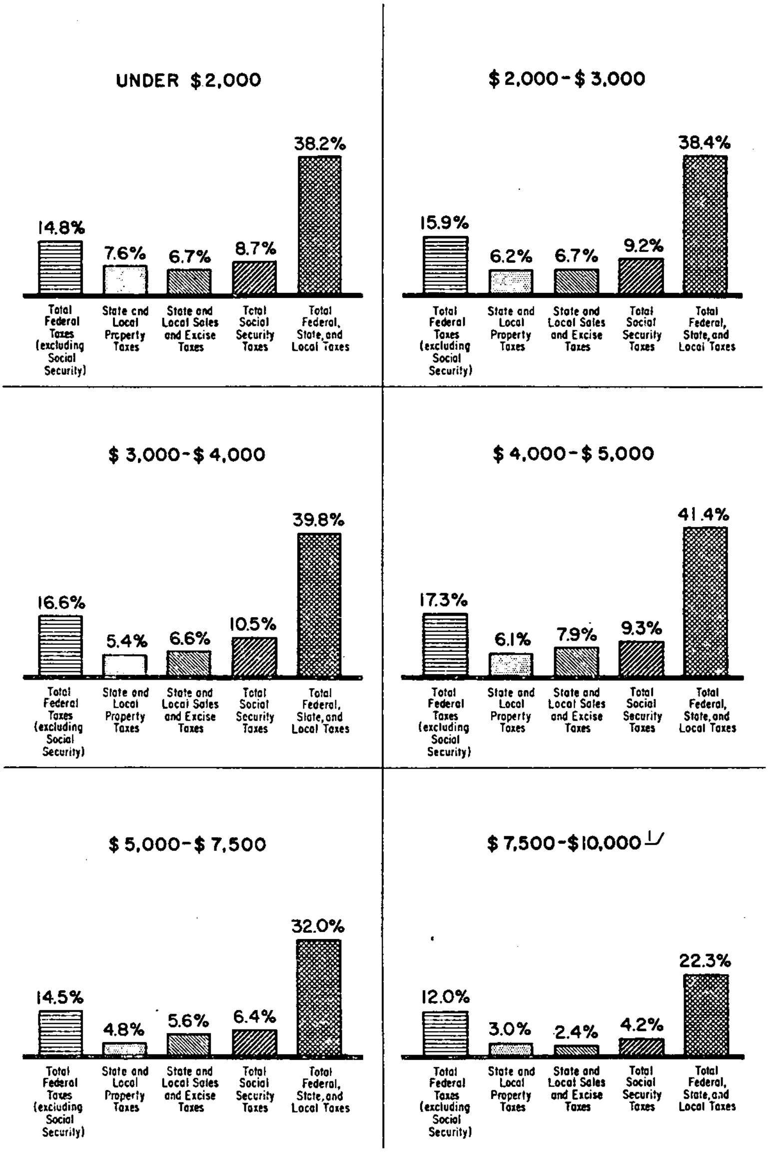
Data: Bureau of the Census.



1/Adjusted gross income levels. 2/Estimated

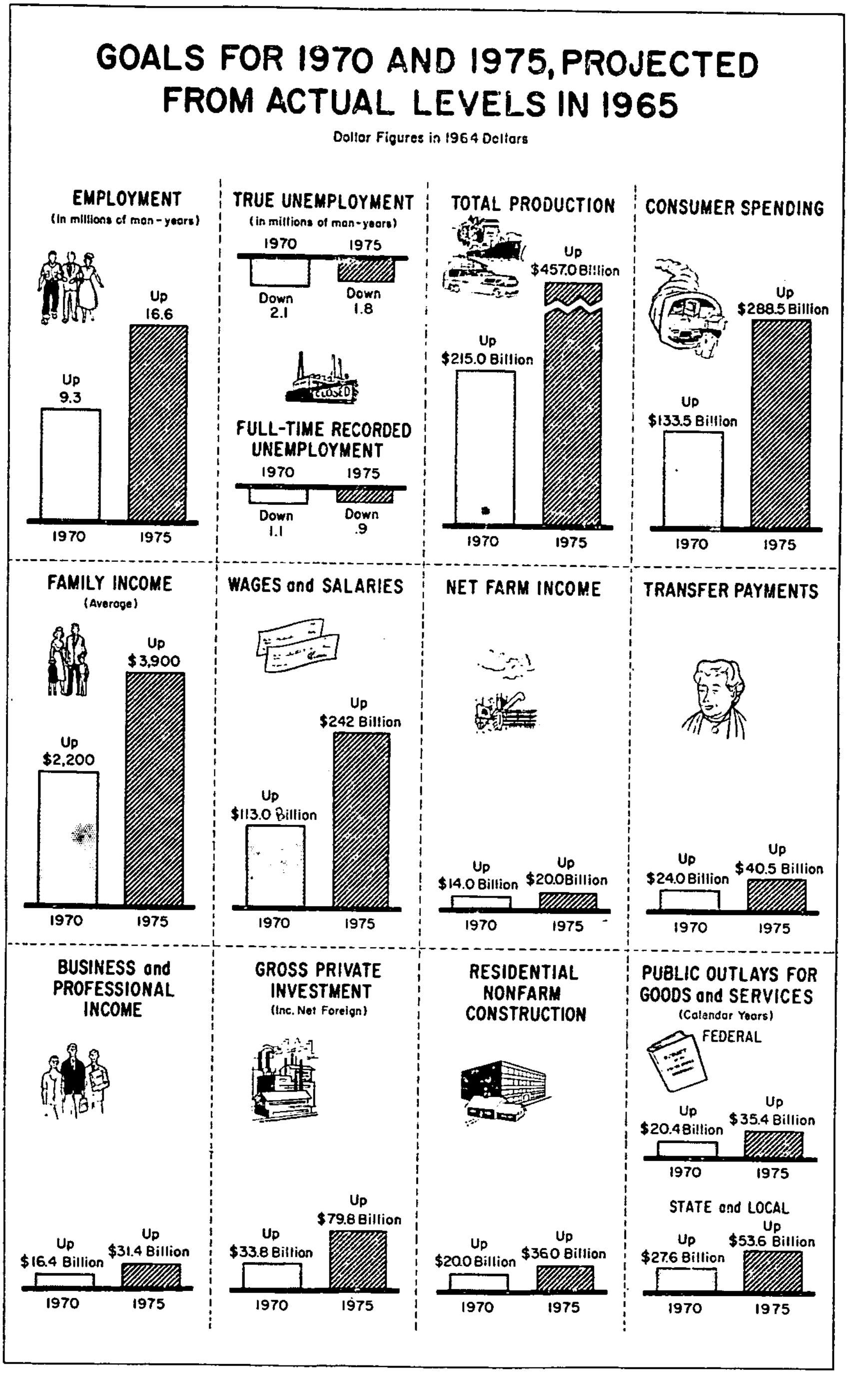
Note: Standard deductions for $ 3,000 income level. Typical itemized deductions for other income levels.

TAXES PAID AS % OF INCOME, U.S., 1960

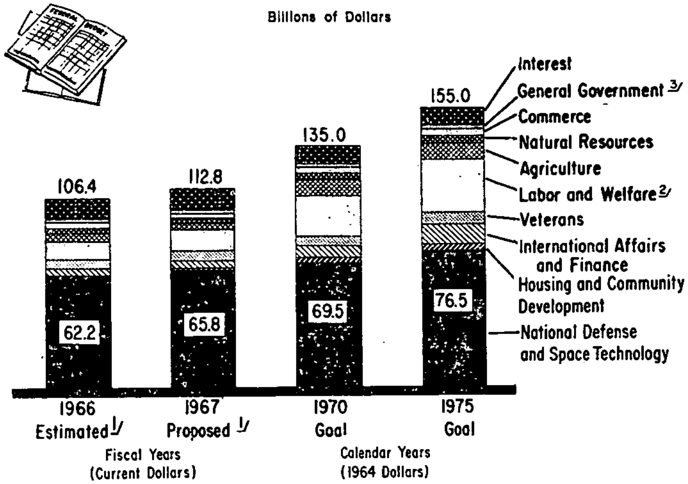


1/ Total Federal, State, and Local Taxes for those with incomes $10,000 and over, 31.6%.

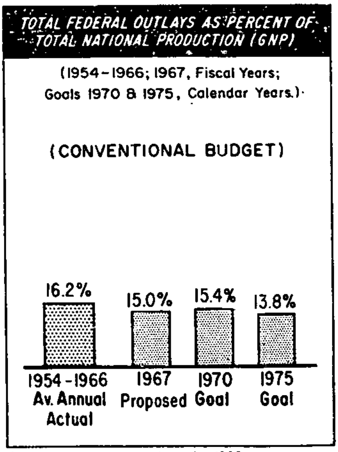
Source: Brookings Institution; income equals the Brookings study's "broad income concept" plus personal transfer payments.

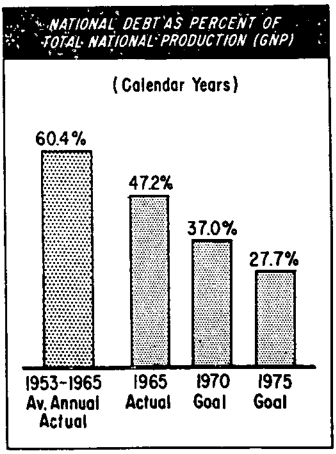

GOALS FOR 1970 AND 1975, PROJECTED FROM ACTUAL LEVELS IN 1965
Dollar Figures in 1964 Dollars
EMPLOYMENT
(In millions of man-years)
Up 9.3
Up 16.6
1970
1975
TRUE UNEMPLOYMENT
(in millions of man-years)
1970
1975
Down 2.1
Down 1.8
CLOSED
FULL-TIME RECORDED UNEMPLOYMENT
1970
1975
Down 1.1
Down .9
TOTAL PRODUCTION
Up $215.0 Billion
Up $457.0 Billion
1970
1975
CONSUMER SPENDING
Up $133.5 Billion
Up $288.5 Billion
1970
1975
FAMILY INCOME
(Average)
Up $2,200
Up $3,900
1970
1975
WAGES and SALARIES
Up $113.0 Billion
Up $242 Billion
1970
1975
NET FARM INCOME
Up $14.0 Billion
Up $20.0 Billion
1970
1975
TRANSFER PAYMENTS
Up $24.0 Billion
Up $40.5 Billion
1970
1975
BUSINESS and PROFESSIONAL INCOME
Up $16.4 Billion
Up $31.4 Billion
1970
1975
GROSS PRIVATE INVESTMENT
(Inc. Net Foreign)
Up $33.8 Billion
Up $79.8 Billion
1970
1975
RESIDENTIAL NONFARM CONSTRUCTION
Up $20.0 Billion
Up $36.0 Billion
1970
1975
PUBLIC OUTLAYS FOR GOODS and SERVICES
(Calendar Years)
FEDERAL
Up $20.4 Billion
Up $35.4 Billion
1970
1975
STATE and LOCAL
Up $27.6 Billion
Up $53.6 Billion
1970
1975

TOWARD A FEDERAL BUDGET CONSISTENT WITH MAXIMUM EMPLOYMENT AND THE PRIORITIES OF NATIONAL PUBLIC NEEDS



BURDEN OF FEDERAL OUTLAYS IN A FULLY GROWING ECONOMY WOULD BE LOWER THAN IN RECENT YEARS





1/ As of Budget Message of Jan. 24, 1966.

2/ Including education and health services

3/ Including contingencies and less interfund transactions

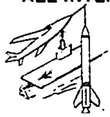
GOALS FOR A FEDERAL BUDGET GEARED TO ECONOMIC GROWTH AND PUBLIC NEEDS

1967, fiscal year; 1970 and 1975, calendar years
Totals for 1967 in current dollars;
All other dollar figures in 1964 dollars.

ALL FEDERAL OUTLAYS

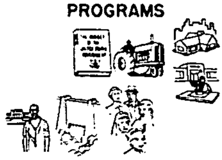
Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1967 Adm.[1]	112.847	521.79	15.05
1970 Goal	135.000	645.93	15.38
1975 Goal	155.000	685.84	13.84

NATIONAL DEFENSE, SPACE TECHNOLOGY, & ALL INTERNATIONAL



Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1967 Adm.[1]	70.018	323.77	9.34
1970 Goal	77.500	370.82	8.83
1975 Goal	87.500	387.17	7.81

ALL DOMESTIC PROGRAMS



Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1967 Adm.[1]	42.829	198.04	5.71
1970 Goal	57.500	275.12	6.55
1975 Goal	67.500	298.67	6.03

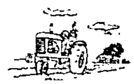
ECONOMIC OPPORTUNITY PROGRAM

Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1967 Adm.[1]	1.600	7.39	0.21
1970 Goal	4.000	19.14	0.46
1975 Goal	6.000	26.55	0.54

HOUSING AND COMMUNITY DEVELOPMENT

Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1967 Adm.[1]	0.123	0.57	0.02
1970 Goal	3.350	16.03	0.38
1975 Goal	3.800	16.81	0.34

AGRICULTURE; AND NATURAL RESOURCES



Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1967 Adm.[1]	6.434	29.75	0.86
1970 Goal	10.500	50.24	1.20
1975 Goal	12.000	53.10	1.07

EDUCATION

Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1967 Adm.[1]	2.834	13.10	0.38
1970 Goal	7.000	33.49	0.80
1975 Goal	9.500	42.04	0.85

HEALTH SERVICES AND RESEARCH

Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1967 Adm.[1]	3.621	16.74	0.48
1970 Goal	4.800	22.97	0.55
1975 Goal	7.000	30.97	0.62

PUBLIC ASSISTANCE; LABOR, MANPOWER, AND OTHER WELFARE SERVICES

Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1967 Adm.[1]	4.741	21.92	0.63
1970 Goal	6.600	31.58	0.76
1975 Goal	7.500	33.18	0.67

[1] Administration's Proposed Budget as of Jan. 23, 1966.

APPENDIX

THE AMERICAN BANKERS ASSOCIATION,
New York, N.Y., April 1, 1966.

Representative MARTHA W. GRIFFITHS,
Chairman, Subcommittee on Fiscal Policy, Joint Economic Committee, New Senate Office Building, Washington, D.C.

DEAR REPRESENTATIVE GRIFFITHS: This letter is in response to your invitation to the American Bankers Association to submit a written statement on the topic of your subcommittee's hearings, "Prompt Tax Changes for Economic Stabilization." My response has been approved by our economic policy committee and by our governing body, the American Bankers Association's Administrative Committee.

In our comments on the President's 1966 Economic Report, submitted at the request of the chairman of the Joint Economic Committee earlier this year, we stated:

"In the interest of economic stability, we believe it only consistent to pledge our support for equitable and properly structured tax increases, soundly conceived for the purpose, if such prove necessary to avoid inflation in the period ahead."

Recent events convince us that such an increase is now desirable, but we repeat our strongly held view that "no request for an emergency tax increase should be made or granted without firm accompanying efforts to cut back on domestic spending proposals." In this respect, we noted that even though war-induced spending is adding significantly to inflationary pressures, the administration proposes a further increase of $3.2 billion for major domestic programs of social legislation in fiscal year 1967.

The case for a combined domestic spending cut and tax increase can be stated succinctly. The inflation which appeared to be a strong possibility only 2 months ago is now a fact. If allowed to continue, it will not only create serious inequities in the economy but also threaten the sustainability of the economic advance that began in 1961 and erode our international competitive position.

That we have not had even more inflation than has already occurred—both consumer and wholesale prices have risen strongly in recent months—must be attributed primarily to the restraining impact of Federal Reserve monetary policy. But we are in imminent danger of placing too heavy a burden on monetary policy. Already pressures in credit markets are severe and interest rates have risen to the highest levels in several decades. These pressures may intensify as the Government continues with its plans to liquidate almost $5 billion of financial assets in the coming fiscal year, and as the speedup in payment of Federal income taxes, which works primarily through reducing liquidity of individuals and businesses, takes effect.

Monetary policy is capable of carrying a substantial portion of the stabilization burden, but it must not be called upon to carry too much; highly restrictive monetary policies can create severe strains in the economy. Fiscal policy and debt management must also bear their appropriate share of the stabilization load. The evidence is now convincing that the degree of fiscal restraint implicit in the President's January budget message is insufficient to the task. It is now time to move firmly in making certain that fiscal policy bears its appropriate part of the burden, thus easing the load on monetary policy and helping greatly to relieve pressures in financial markets.

Fear that increased fiscal restraint would exert too much drag on the economy should not be permitted to forestall action. Restraint, in the form of a highly restrictive monetary policy, is already severe; the major purpose of increased fiscal restraint would be to relieve monetary policy of part of the stabilization task—a step which we believe would help sustain the economic advance. Nor need the combined spending cut and tax increase be large; current opinion indicates that a combined impact of $4 to $6 billion (on a fiscal year basis) would probably be sufficient. If events indicated that this degree of restraint, coupled with monetary and fiscal actions already taken, threatened to be too severe, the moves toward greater fiscal restraint could be modified or, if already in effect, reversed.

In your letter of March 11, you asked us specifically to comment on three topics: (1) The contribution of rapid tax changes to stabilization; (2) the criteria for such tax changes; and (3) the technical design of such changes. Several of these points were covered in some detail in a speech I delivered on March 8. With the approval of our Economic Policy and Administrative Committees, I am enclosing a copy of that speech for inclusion in the record.

I. THE CONTRIBUTION OF RAPID TAX CHANGES TO STABILIZATION

With respect to this topic, you ask: Do we need to be able to react more promptly to changing economic stabilization requirements? What economic effects are likely to be associated with rapid tax changes?

We believe that, as a general proposition, tax changes should not be used for purposes of shortrun economic stabilization, and that major reliance should instead be placed on monetary policy. Tax changes—especially increases—represent a rather abrupt change in the "rules of the game" for the affected individuals and institutions. This type of abrupt change in economic ground rules should, we believe, be avoided as much as possible in a market economy.

Moreover, under most conditions shifts in monetary policy, reinforced by the built-in flexibility of the Federal fiscal system, can bear the major portion of the shortrun stabilization burden. Still another argument for favoring monetary over tax policy for such purposes is the fact that shifts toward monetary ease or restraint can be administered in very small gradations, whereas tax changes must of necessity be larger in amount.

Emergency conditions can arise, however, in which rapid fiscal actions are clearly desirable. Such emergency conditions would include a sharp expansion in military requirements, which might justify both a cutback in domestic spending and a broadly based tax increase, and a precipitate decline in economic activity, which might justify a quick tax reduction. The danger in both of these instances is that, if spending and tax policies are not quickly adjusted, monetary policy will be asked to carry too large a portion of the stabilization task.

We are convinced that the Congress, which has moved rapidly to adjust taxes to emergency situations in the past, can be relied upon to continue to do so in the future, provided a simple and clear-cut proposal is presented by the administration of the day. For this reason we are not at this time prepared to support any novel or radical changes in the governmental mechanism for effecting tax changes, including the granting of standby authority to the President or the enactment of a standby tax increase or decrease to be "triggered" by presidential action and a supporting congressional resolution.

As to the economic effects likely to be associated with a rapid tax change, we see no reason to believe that the impact would not be substantially the same as those that are effected after relatively long periods of deliberation: An increase can be expected to reduce aggregate demands for goods and services and a decrease to increase such demand. This is especially true if whatever portion of the change that applies to individuals is immediately put into effect through a change in the amount of taxes withheld from current income.

II. CRITERIA FOR RAPID TAX CHANGES

With respect to this topic, you ask: What principles should govern the design of such tax change? Should the changes be neutral, and what is neutral change? If not, what specific nonneutralities with respect, for example, to relative impacts on various classes of taxpayers and type of income, and on consumption and investment, should be provided? Do criteria for the changes vary with circumstances?

Tax changes to meet emergency stabilization goals should be as nearly neutral and impartial as can be devised; structural changes should be strictly avoided. Moreover, the need for rapid action dictates against complex proposals; changes should be simple and easy to understand.

"Neutrality" with respect to a tax increase or decrease is impossible to define precisely. As between individuals and corporations, one approach to neutrality or impartiality might be to maintain the proportionate tax burdens for the two groups. For example, individuals now bear 65.7 percent of the total income tax burden and corporations bear 34.3 percent; thus an increase or decrease that maintained this relative burden might be considered to be neutral.

Difficult problems also arise with respect to low- and high-bracket individual income taxpayers. Simplicity would seem to require one of two approaches; an across-the-board increase or decrease by the same number of percentage points in each bracket, or a flat percentage increase or decrease in the tax paid by each individual. In the former case, if taxes were increased, individuals in low-income brackets would pay more proportionately than those in higher brackets. Conversely, if taxes were reduced, the percentage drop would be larger in the lower brackets.

We have no pat solution to the problems of neutrality as between income brackets, but the foregoing discussion does seem to indicate that the attainment of some degree of neutrality as between such groups for both tax increases and decreases may require some combination of the two approaches mentioned above. On the other hand, the highly desirable attribute of simplicity would probably call for one approach or the other, rather than a combination of the two.

Inasmuch as simplicity and neutrality are prime requisites for rapid tax action, any attempt to attain differential impacts on consumption and investment, or other important economic variables, should be strictly avoided. The only aim should be to increase or decrease aggregate demand, and to do so quickly and effectively. Structural changes should be effected slowly, after the most careful consideration and full opportunity for debate.

An important example of a structural tax increase which definitely should not be enacted under today's conditions is partial or complete suspension of the 7-percent tax credit for investment in new productive equipment. The credit was proposed originally as a central part of a broad, long-range program to promote economic growth by fostering business investment in productive equipment. It was adopted by the Congress as part of the Revenue Act of 1962, but only after 17 months of discussion, study, and debate. To attempt to convert the credit into a shortrun stabilization device which would be lowered in booms and raised in recessions would run the serious risk of impairing its effectiveness in serving its original purpose. Businessmen, who originally were reluctant to accept the proposal, would rightly conclude that the apparent tax savings flowing from the credit might, given a change in the economic climate, turn out to be illusory.

Other arguments, which are presented in detail in the speech that accompanies this statement, suggest the wisdom of retaining the credit in its present form. A change in the credit would hit some business much harder than others, thus increasing the differential impact of any proposed tax increase and impairing its political acceptability. Inasmuch as equitable application of any suspension would probably require exemption for projects underway, the major impact of the suspension on investment demand would be delayed for several months. This would risk exerting a strongly dampening influence on investment just at the time the Vietnam situation might be improving, or when the economy's ability to produce was catching up with demand.

It should also be noted that the tight capital market conditions of recent months, coupled with any proposed increase in the corporate profits rate, will work strongly to curtail investment spending. These restraints will operate not just on investment in productive equipment—which actually is a strong force working ultimately to abate inflationary pressures—but on inventory accumulation and other types of business and public investment which add little directly to the economy's ability to turn out goods and services.

Similar arguments could be raised against other structural changes that, for one reason or another, might be included as a part of a stabilization tax measure. To repeat: shortrun tax changes for stabilization purposes should be simple and as neutral and impartial as possible; structural changes should be strictly avoided.

III. TECHNICAL DESIGN

With respect to this topic, you ask: What types of changes in which taxes should make up the total tax action? Can suitable changes be composed from existing taxes or do we need new taxes for this propose?

Since the exigency of the type of situations herein described militates against either structural or complex tax changes, the proper approach would be to limit such changes to simple increases or decreases, applied across the board and to individuals and corporations alike. As noted above, special tax provisions such as the investment credit should not be tampered with under such circumstances.

No new taxes are needed for this purpose. Although a strong case can be made for some sort of value-added imposition, the desire to aviod structural changes should preclude the adoption of this or any other new form of taxation; the proposal to do so would result only in lengthy debate and delay. Moreover, if the objective of the action is to stimulate or diminish aggregate demand, without attempting to differentiate among its various components, then variations in income taxes surely provide a broadly based and effective means of doing so.

As noted at the outset, the American Bankers Association is convinced that a combined spending cut and tax increase is now necessary if inflation is to be contained. Otherwise, we run the serious risk of relying entirely too heavily on monetary policy to see us through this difficult period. Still, it should be emphasized that the need for these firmer fiscal actions might be relatively short lived. Accordingly, we urge that any tax increase be temporary, scheduled to expire in mid-1967 or, at the latest, the end of that year. Hopefully, by that time the combination of fiscal and monetary actions would have held back aggregate demand and, assuming no further substantial escalation of the Vietnam war, supply would have expanded sufficiently to meet demand without undue pressures on costs and prices.

But if this were not the case—if inflationary pressures remained a serious threat—Congress would have had time to act in order to prevent the lapse of the emergency tax increase. Experience has demonstrated that emergency wartime taxes, once enacted, are difficult to remove. The suggested procedure, although not foolproof, would help assure that such taxes would be removed once they had served their fundamental purpose.

Thank you very much for the opportunity of commenting on this highly important matter.

Sincerely yours,

CHARLS E. WALKER.

THE ECONOMICS AND POLITICS OF AN INCOME TAX INCREASE

(Remarks of Dr. Charls E. Walker, executive vice president, the American Bankers Association, New York, before the Golden Key Society banquet, Columbus Chapter, American Society of Chartered Life Underwriters, Columbus, Ohio, Tuesday evening, March 8, 1966)

The time has come for President Johnson to announce to the Nation that he will seek both a decrease in planned domestic spending and an income tax increase to help keep the inflationary pressures stemming from the Vietnam war from overheating an already taut economy. If inflationary forces are allowed to gain the upper hand, the prospects of sustaining the long period of economic advance will be slim indeed.

My purpose tonight is not to set forth the economic arguments justifying firmer fiscal actions at this time. The vast majority of informed observers outside Government seem fully convinced that such actions are necessary. And the preponderance of opinion, as I interpret it, is that the combined spending cut and tax increase should add up to a net impact of $4 to $6 billion in the coming fiscal year.

Rather, my purpose tonight is to discuss some economic and political considerations surrounding any proposed tax increase. For if such an increase is proposed, it is important that it be properly designed to do the job for which it is intended. And it is highly important that it move speedily through the Congress.

I am not one who believes Congress will always move slowly in considering major tax legislation. When the need is urgent and the proposal simple and equitable, Congress can and does act quickly. For example, the $5 billion Korean war tax increase in 1950 passed the Congress in less than 2 months. Note also the tax proposal presented to the Congress in January of this year which is expected to become law this week.

The record is clear; Congress can and will act with dispatch when speed is necessary. Those skeptics who point to congressional inaction in 1958, when many economists believed an emergency tax decrease should have been enacted, overlook the fact that no administration proposal for tax reduction was ever made. And the 16 months required for the Kennedy income tax proposal of 1963 to move through the Congress resulted primarily from the many structural changes in the original proposal—always a matter of lengthy congressional consideration—and the reluctance of the President to accompany the proposed cut with even a leveling off of Federal spending.

The experience with the income tax reduction provides valuable lessons for today's problem. First, the increase should be as nearly neutral and impartial as can be devised and structural changes should be strictly avoided.

Second, the proposal should be simple and easy to understand. Otherwise, unnecessary time might be consumed in clarifying its provisions. More important, a complex proposal would endanger the broad public support that is essential for quick congressional action.

Third, the increase should apply to the income taxes of both individuals and corporations. Although a theoretical case might be made for concentrating on one group or the other, the need for swift action dictates against any such finely tuned differentiations at this time. The economics of the situation are such that any diminution in purchasing power, widely and equitably diffused, will help take steam out of the economy. And the politics of the situation are that any proposal which favored one group against another could lead to long delays in congressional action.

This is one of the major reasons for arguing strongly against elimination or reduction of the 7-percent investment credit, as proposed by some observers. A change in the investment credit would hit some businesses much harder than others, thus impairing the political acceptability of a tax increase. Nor is the economic argument supporting reduction or elimination of the credit convincing. According to this argument, business capital spending is proceeding at an unsustainable pace and, in effect, is adding the bubble to the boom.

That we are in the midst of a major capital goods boom is beyond dispute. But to jump from this fact to the conclusion that the best way to fight inflation in 1966 is to tinker with the investment credit is to make a very big jump indeed. The credit was proposed originally as a central part of a broad, long-range program to promote economic growth by fostering business investment in productive equipment, and the evidence suggests that it has been signally successful in doing so. To attempt to convert the credit into an anticyclical tool—lowered in booms and raised in periods of slack—would run the serious risk of impairing its effectiveness in serving its original purpose. Businessmen would rightly conclude that the apparent tax savings flowing from the credit might, given a change in economic climate, turn out to be illusory.

The inequity of a reduction in the investment credit and the impairment of its long-run effectiveness might be moderated by exempting from any such reduction projects for which a firm is already committed at the time the decrease took effect, but for which delivery of the machinery had not taken place. This would, however, be only a partial solution. The elapsed time from the date of order until delivery of the machinery is only a part of the total period involved in planning for its installation. Consequently, businessmen who had spent considerable time and effort in planning such a purchase would still feel that an anticyclical reduction in the credit was unfair and would be less likely to place heavy reliance on it in future investment planning.

The exemption of projects for which commitments had been made would also delay significantly the revenue-generating impact of the reduction. More important in this respect, however, is the fact that the impact on investment spending would also be delayed, perhaps for several months, depending upon the average delivery time for machinery covered by the credit. If, as I am arguing, the need for a tax increase is urgent, any such delay in real impact should be viewed as a telling economic argument against reduction of the credit to help contain inflation in 1966.

The fact is that an increase in individual and corporate income taxes, coupled with the increased cost and reduced availability of credit that has occurred in recent months, should be quite effective in dampening investment spending in the months ahead. These restraints will operate not just on investment in productive equipment—which actually is a strong force working ultimately to abate inflationary pressures—but on inventory accumulation and other types of business and public investment which add little directly to the economy's ability to turn out goods and services. Higher individual income taxes will reduce consumers demands for goods and services and curtail the need for expansion in output capacity. Higher corporate income taxes will shrink the after-tax return on new investments, thus reducing their attractiveness.

The tightening of credit markets which we have been witnessing encourages all types of borrowers to reexamine their spending plans. Some borrowers, who must go into the long-term capital markets for a substantial portion of the financing for plant and equipment spending are postponing planned borrowings.

Combined, these factors would do much to reduce the pace of business investment. Reduction of the investment credit on top of these restraints could prove to be much too severe in impact and much too late in taking effect. The danger of too heavy a hand in this area is especially pronounced in view of the fact that the inflationary impact of the Vietnam situation might subside rather quickly. In these circumstances, caution is called for.

The political arguments against a reduction in the investment credit this year are even more compelling than the economic arguments. As noted earlier, elimination or reduction of the credit would involve a sharply differential impact among business firms, thereby subjecting the proposal to heated controversy and opposition. A broad-based and simply constructed income tax increase, although certainly not subject to strong welcome by those whose taxes would be increased, would engender much less controversy.

More is at stake here than the success of an administration proposal for a tax increase in this congressional session. The larger stakes involve a demonstration on the part of the Congress that it can move with dispatch to enact tax legislation when conditions warrant. In so doing, Congress would demonstrate that it need not delegate authority for emergency income tax changes to the Executive. But the chances for speedy congressional action will be greatly impaired if any proposal sent up by the administration departs from the principles of neutrality noted earlier.

Last month, the American Bankers Association pledged its support for "equitable and properly structured tax increases, soundly conceived for the purpose, if such prove necessary to avoid inflation in the period ahead." I am personally convinced that such increases, coupled with a cut in Federal spending, are now necessary, but I do not believe that a proposal involving reduction or elimination of the 7-percent investment credit would be equitable, properly structured, or soundly conceived for the fundamental purpose of containing inflation in 1966.

The economic and political considerations call also for a strong commitment on the part of the administration to reduce planned domestic spending at the same time it proposes a tax increase. According to the Council of Economic Advisers, the projected cost of the war in Vietnam is small relative to gross national product—less than 1½ percent. But the defense budget for fiscal year 1967 is set to rise by another $4 billion, making a total increase of $10 billion in 2 years. At the same time, the administration is proposing a $3.2 billion jump in domestic welfare and education spending.

Is this increase in spending justified? If both you and I were convinced that the additional $3.2 billion would substantially reduce poverty and enhance education by making the underprivileged and the undereducated genuinely better off, both in the short run and for many years ahead, then I doubt that the proposed spending increase would encounter significant opposition. But many Americans are not so convinced. They believe that the far-reaching social programs enacted in the first session of the current Congress should be given time for assimilation and consolidation. And they are likely to object particularly to expansion of such programs when they may be called upon, at the same time, to pay more taxes to finance a war.

Here again, both economic and political factors call for restraint. And, drawing a lesson from the very slow movement through Congress of the Kennedy income tax cut in 1963, early attention to this restraint could greatly enhance the prospects for quick action on an administration-sponsored tax increase. The determination to exercise such restraint should be firmly and clearly set forth in the Presidential message calling for a tax increase. Otherwise, public and congressional opposition to a tax hike could become strong indeed.

To sum up, the evidence is now clear that fiscal policy must assume a larger role in the fight to control inflation in the months ahead. The economy is in serious and imminent danger of overheating and, if this is permitted to occur, the resulting inflation will not only create serious inequities, but will also tend to cut short the life of the economic advance. Moreover, the heavy burden which monetary and credit policy has been forced to assume is creating strains in the financial structure.

Thus the American economy needs a Federal tax increase and spending cut now. And it is critically important that the administration send up a simple and equitable proposal which, without sacrificing the long-range benefits of recent tax policy, will be effective in containing inflationary pressures during the period of the Vietnam emergency.

STATEMENT BY E. S. HALL, ECONOMIST, FREEDOM INC., FARMINGTON, CONN.

PROMPT TAX CHANGES FOR ECONOMIC INVESTMENT

A tax way out of inflation and Vietnam to price stability and peace

1. Prompt tax changes? Which? Our income tax law, the Internal Revenue Code of 1954 as amended, is a monstrosity so complicated that nobody can be sure how the people would vote if a change were made in any part of it. Yet all its inequities and complexities have grown from only two unsound roots:

(*a*) Indirect taxation, the attempt to tax business; and

(*b*) "Progressive" taxation, the attempt to soak the capitalists and benefit the workers. A direct and proportional (flat percentage) income tax law can be equitable and simple, but as long as employees are independent contractors not receiving their parts of profit or loss, they will vote for Congressmen who favor "double" taxes on profits and the "progressive" income tax.

2. Employees are part of the business. As free people, they own themselves. They own part of the business, the human part, but the fact is not yet recognized. Given neither the rights nor the responsibilities of business ownership, their economic freedom is defective. Given neither the incentive of profit nor the risk of loss, they do less and less, demand more and more, and strike for shorter hours and higher wages. Wages are a cost; the price of the product covers both cost and profit. Their parts of profit not paid to them, they lack the purchasing power which would enable them to buy their full shares of the product. These undivided profits, sunk in pension trust and other funds, are invested in existing securities (inflating the security market) instead of being spent for goods. Part of the product remains unsold, inventories pile up, unemployment rises—recession.

3. A recession-causing shortage in employee spending can be filled by Government spending, but deficit spending (of new deposits created by the banks as they "monetize" the bonds) inflates the quantity of credit and money. Whether prices rise or fall is determined by the accompanying rate of production of goods. When Government (by deficit spending) inflates the quantity of credit and money faster than business increases the quantity of goods, prices rise.

4. Inflation is a creeping tax; it weakens the dollar, robs us of purchasing power, causes strikes for higher wages, hurts our competitive position in world markets and our balance of payments. Inflation is "the cruelest tax," a tax eroding fixed incomes (pensions, compensation, insurance, social security), a rising tax on millions who cannot get a raise.

5. Inflation doesn't just happen; it's a crime committed by Government in an attempt to avert recession and promote prosperity and economic growth toward full employment. Government commits this insidious crime (inflation by deficit spending) mainly because our income-tax law, the Internal Revenue Code of 1954 as amended, is inadequate. Thousands of pages—yet it doesn't even collect enough revenue to keep up with spending and prevent inflation.

6. Government's responsibility is to steer between inflation and deflation by increasing (or decreasing) the quantity of credit and money at the same rate that business increases (or decreases) the quantity of goods. Market operations in Government securities, and adjusting reserve requirements and interest rates, may govern the quantity of credit. Taxing the national income, and adjusting the tax rate automatically in response to price trends, could govern the quantity of money and give us free-market price stability.

7. We need an adequate, simple, adjustable-rate tax law, a law to recognize the fact that employees own themselves, the human part of the business. When employers and employees are limited partners receiving their respective parts of profit or loss, they will all try to increase profit and prevent loss. No strikes. And a simple proportional income tax law will be politically desirable, a real vote getter, the freedom tax law for example, a law that will:

(*a*) Let employers elect to withhold a simple tax on profits, salaries and wages (instead of the complex taxes of the Internal Revenue Code of 1954 as amended). Comparisons made from annual reports show that, in a profitable business, everyone concerned will get a tax cut, a take-home raise.

(*b*) Taxing the broadest tax base (national income) insures lowest rate, 20 percent collecting $110 billion. Adjust the rate automatically as a governor on the general price level. Free market price stability.

(*c*) Let the needy elect to change from partial to total security, locallly administered by social workers and the clergy, and payable from income tax revenues. No accounting overhead. Lowest cost to taxpayers.

8. An example of industrial peace and price stability in the United States will shine with a light so bright it will penetrate the iron-bamboo curtain and expose Karl Marx as a quack. Communists and Socialists will be left without a mission, left with nothing to fight for. The war in Vietnam—all "wars of liberation"—will cease. We can lead the world toward peace.

1. Communists, brainwashed by Karl Marx, believe it is their mission to liberate nations from capitalism and socialize the world. Neither months nor years nor decades of killing Communists in Vietnam can induce them to quit, but an idea could. "No army is as powerful as an idea whose time has come."

2. Government spending has given us 5 years of prosperity, but, in the following equation, when deficit spending raises the numerator, dollars, faster than business, raises the denominator, goods, the ratio, price, rises.

$$\frac{\text{number of dollars spent}}{\text{number of units of goods paid for}} = \text{average price of goods}$$

3. Inflation is a creeping tax: it weakens the dollar, robs us of purchasing power, causes strikes for higher wages, hurts our competitive position in world markets, and our balance of payments. Inflation is "the cruelest tax"; it erodes fixed incomes (pensions, compensation, insurance, social security) ; it is a rising tax on the millions who cannot get a raise.

4. Inflation doesn't just happen; it's a crime committed by Government in an attempt to avert recession and prolong prosperity toward full employment. Government commits this crime (inflation by deficit spending) mainly because our income tax law, the Internal Revenue Code of 1954; as amended, is inadequate. Thousands of pages—yet it doesn't even collect enough revenue to keep up with spending and prevent inflation. Prompt tax changes? Which? The Internal Revenue Code is a monstrosity so complicated that nobody can be sure how the voters would react if a change were made in any part of it. Yet all its inequities and complexities have grown from two unsound roots: (1) Indirect taxation, the attempt to tax business ("double" taxes on profits) and (2) "progressive" taxation, the attempt to soak the capitalist and benefit the workers. A direct and proportional (flat-rate) income tax law can be adequate and simple, but as long as employees are independent contractors not receiving their parts of profit or loss, they will vote for Congressmen who favor "double" taxes on profits and the "progressive" income tax.

5. Employees are part of the business. As free people, they own themselves. They own part of the business, the human part. Why not recognize the fact by making them limited partners? When employers and employees are limited partners receiving their just parts of profit or loss, they will all try to increase profit and prevent loss. No strikes. And a simple proportional income tax law will be politically astute, a real votegetter, the freedom tax law for example, a law that will—

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(2) Taxing the broadest tax (national income) insures lowest rate, 20 percent collecting $110 billion. Adjust the rate automatically as a governor on the general price level. Automatic free market price stability.

(3) Let the needy elect to change from partial to total security.

6. An example of industrial peace and price stability in the United States will shine with a light so bright it will penetrate the Iron-Bamboo Curtain and expose Karl Marx as a quack. Communists and other Socialists will be left without a mission, left with nothing to fight for. The war in Vietnam—all "wars of liberation"—will cease. We can lead the world toward peace.

A TAX GOVERNOR ON THE PRICE LEVEL—AUTOMATIC PRICE STABILITY

1. Government spending has been a factor in giving us 5 years of prosperity, but, in the following equation, when deficit spending raises the numerator, dollars, faster than business raises the denominator, goods, the ratio, price, rises.

$$\frac{\text{number of dollars spent}}{\text{number of units of goods paid for}} = \text{average price of goods}$$

2. Inflation is a creeping tax; it weakens the dollar, robs us of purchasing power, causes strikes for higher wages, hurts our competitive position in world markets and our balance of payments. As stated by CED, inflation is "the cruelest tax," a tax eroding fixed incomes (pensions, compensation, insurance, social security), a rising tax on millions who cannot get a raise.

3. Inflation doesn't just happen; it's a crime committed by Government in an attempt to avert recession and extend prosperity toward full employment. Government commits this crime (inflation by deficit spending) mainly because our income tax law, the Internal Revenue Code of 1954 as amended, is inadequate. Thousands of pages—yet it doesn't even collect enough revenue to keep up with spending and prevent inflation. Prompt tax changes? Which?

4. The Internal Revenue Code is a monstrosity so complicated that nobody can be sure how the voters would react if a change were made in any part of it. Yet all its inequities and complexities have grown from two unsound roots: (1) Indirect taxation, the attempt to tax business ("double" taxes on profits) and (2) "progressive" taxation, the attempt to soak the capitalists and benefit the workers. A direct and proportional (flat rate) income tax law can be equitable and simple, but as long as employees are independent contractors not receiving their parts of profit or loss, they will vote for Congressmen who favor "double" taxes on profits and the "progressive" income tax.

5. Employees are part of the business. As free people, they own themselves. They own part of the business, the human part. Why not recognize the fact by making them limited partners? When employers and employees are limited partners receiving their just parts of profit or loss, they will all try to increase profit and prevent loss. No strikes. And a simple proportional income tax law will be politically desirable, a real votegetter, the freedom tax law, for example, a law that will—

(1) Let employers elect to withhold a simple tax on profits, salaries, and wages (instead of the complex taxes of the Internal Revenue Code of 1954 as amended). Taxing the broadest tax base (national income) insures lowest rate, 20 percent collecting $110 billion. Comparisons made from annual reports show that, in a profitable business, everyone will get a tax cut, a take-home raise.

(2) Adjust the tax rate automatically in response to price trends as a governor on the general price level. Automatic free-market price stability.

(3) Let the needy elect to change from partial to total security.

6. Government's responsibility is to steer a course between inflation and deflation by increasing (or decreasing) the quantity of credit and money at the same rate that business increases (or decreases) the quantity of goods. Market operations in Government securities, and adjusting reserve requirements and interest rates, may govern the quantity of credit. Taxing the national income, and adjusting the rate automatically in response to price trends, could govern the quantity of money and give us automatic price stability.

STATEMENT BY W. E. HAMILTON, DIRECTOR OF RESEARCH, AMERICAN FARM BUREAU FEDERATION, CHICAGO, ILL.

We appreciate the invitation to submit a statement for the record of the hearings the Subcommittee on Fiscal Policy has been holding on the need for, and design of, tax changes which could be enacted promptly as an aid to economic stabilization.

The idea that prompt changes in taxes could contribute to economic stability has considerable theoretical appeal; however, as a practical matter the possibilities of this approach appear to depend upon the ability of the Congress to take quick action on matters that are often highly controversial.

The power to levy taxes is one of the most important powers conferred on Congress by the Constitution. As an organization which believes that we should maintain the checks and balances provided by the constitutional separation of governmental powers, Farm Bureau believes that it would be undesirable for Congress to delegate the authority to change tax rates to the administrative branch of Government.

The use of a formula to trigger automatic changes in taxes also appears to be undesirable. It would be difficult, and probably impossible, to devise a formula that would work appropriately under all circumstances.

The idea of developing proposed changes which could be put into effect by a simple resolution of the Congress is subject to a similar objection. There is no assurance that changes planned in advance would necessarily prove to be the best possible course of action when the time came for the Congress to consider a resolution to put them into effect. Tax changes should continue to be made, as they now are, on the basis of the best judgment of the administration and the Congress at the time the change is enacted.

Although we were not in complete agreement with the provisions of the tax legislation enacted earlier this year, the record of congressional action on this measure seems to us to demonstrate the ability of the Congress to take prompt action on tax changes.

While we do not think that it is practical or desirable to change our traditional process of establishing tax rates, advance studies of the effects of possible changes—such as the study now being conducted by your subcommittee—undoubtedly can make important contributions to prompt action by the Congress. Frequent studies of tax problems should be made, both by the administrative branch of the Government and the appropriate congressional committees so that needed information will be available to facilitate prompt action when the need arises. Advance studies can also help to improve public understanding of important tax policy issues.

In the present situation, we believe the Congress would be well advised to give careful consideration to the possibility of reducing revenue needs by reducing or eliminating expenditures for some of the less essential aspects of the Federal budget before approving any further increases in taxes.

Government expenditures are being increased by high priority defense needs; however, there has also been a vast expansion of domestic programs in recent years. In view of the inflationary pressures now becoming increasingly apparent, the need for programs originally undertaken to stimulate the economy certainly should be reexamined.

The current uptrend in direct payments to farmers also provides an excellent example of the opportunities that exist for judicious reductions in Government spending. The Department of Agriculture is currently estimating that direct payments to farmers will rise from $2.45 billion in the calendar year 1965 to $3.45 billion in 1966. At the same time, the Government is using its stocks of farm commodities to depress farm prices. It does not make sense, either from the standpoint of farmers or the standpoint of the Federal budget, for the Government to depress farm prices and thereby force farmers to depend on Government payments for a substantial part of their income. A shift toward greater reliance on the market system would benefit both farmers and the Federal budget.

In conclusion we wish to urge that the subcommittee give careful consideration to the following views and recommendations with respect to key aspects of future tax policy:

(1) The underlying philosophy of the Revenue Act of 1964—namely the idea that high tax rates act as a drag on the economy—is basically sound. From this standpoint, taxes are still too high; therefore, longrun policy should be directed toward lower rates even though temporary increases may become necessary from time to time.

(2) Economic growth increases the revenues from existing taxes. To insure the continuation of a desirable growth trend, Government spending should be restrained so that a portion of future increases in the revenue-producing capacity of existing tax rates can be used to reduce these rates.

(3) The investment credit should be repealed. This provision of the tax code seems to us to be an undesirable gimmick which may be stimulating an excessive amount of investment in the present setting. A temporary suspension of this

credit would be undesirable: it should be repealed outright in order to terminate its effects on investment decisions.

The liberalized depreciation rules now in effect provide a considerable stimulus to investment. If a further stimulus should be found necessary in the future, it should be provided through a further modification of the depreciation rules and lower tax rates rather than an investment credit.

(4) As a longrun objective, Federal excise taxes should be limited to nonessentials and user taxes such as the tax on passenger transportation by air and the taxes now committed to the highway trust fund.

(5) In any income tax reduction program cuts in rates should have priority over proposals which would reduce substantially the number of taxpayers.

(6) Any increase in income taxes that may become necessary should have a definite expiration date.

Statement by William Jackman, President, Investors League, Inc., New York

Mrs. Chairman and members of the committee, my name is William Jackman. I am president of Investors League, Inc., New York. The Investors League is a nonprofit, nonpartisan, voluntary membership organization of thousands of investors, small and large, residing in the 50 States of the Union.

I wish to thank you for the privilege of appearing before your distinguished committee to testify on behalf of America's many millions of taxpaying voting investors as to from what areas new Federal tax revenues can most equitably be obtained if the mounting costs of war and threats of inflation make such revenue increases necessary.

We doubt very much that the Nation needs to be able to act more quickly through taxation to stimulate or dampen down the economy. The shotgun approach to new tax increases must not be used to circumvent thorough discussion and debate by Congress. The decision should not be delegated to the administration. Federal taxation under our Constitution is the function initially of the House of Representatives whose tax writing committee is the Committee on Ways and Means. Let's keep it that way.

We should not tax either the rich nor the poor nor the corporations more heavily as a special class. Remember that corporations are only people and corporate income taxes are paid twice by their stockholders. Also remember that corporate taxes represent a cost of doing business and must ultimately be reflected in higher consumer prices.

The new tax rates that might be required would depend entirely on the extra revenue needs and should be applied equitably to all groups and individuals.

Before across-the-board tax increases are imposed, every effort should be made to cut deferable nonessential Government spending programs.

We wish to specifically suggest for your consideration, three areas from which substantial new revenues can most equitably be raised:

First, we believe that rescission of Federal excise tax reductions scheduled for telephones and automobiles was unfair and unnecessary. The Treasury would only gain $1,170 million in revenues from this tax. If Federal excise taxes are to be imposed on American manufacturers, they should be imposed at the manufacturers' level at very low and identical rates on all manufacturers with the possible exception of food industries. Telephones and automobiles today are necessities, not luxuries. Why single them out? Base of collection is no excuse for inequity.

Second, we believe that the most painless method of raising revenues from people most able to afford to pay it, would be to cut the unrealistic maximum tax rate on long-term capital gains from 25 percent to 12½ percent as provided in H.R. 12301 now pending before the House Committee on Ways and Means.

Such a tax would benefit elderly homeowners tremendously. These taxes on long-term capital gains are largely no tax on income at all, but a tax on capital and thoroughly punitive in character.

People who have had substantial stockholdings for a long period of time will not sell and reinvest because of the high tax rate involved. A recent survey conducted by the highly respected firm of Louis Harris & Associates, Inc., concludes that if the maximum capital gains tax rate were reduced to 12½ percent, the market value of sales by all individual investors would soar from

$10.3 to $67.3 billion. Total capital appreciation of $29.2 billion would become subject to the lower capital gains tax rate. Thus, nearly seven times as much stock would be sold. Nearly 10 times as much capital appreciation would be unlocked and thus become subject to the lower capital gains tax rate. In terms of dollars, $57 billion more of capital would be freed for reinvestment than under the present rates, and the Treasury would receive $2.5 billion in revenue—over $2 billion more than under the present rates.

Gentlemen, here is a tax rate reduction that will give the Government a substantial new source of revenue which will be contributed willingly by the rich and enable the poor to have their excise tax reduction which they so thoroughly deserve.

Third, today, one-fourth of the consumers of electricity pay no Federal income taxes in the rates charged them while the other three-fourths pay an annual Federal tax of 11 cents out of each dollar they pay for electricity. These taxes go largely for national defense and interest on the national debt.

Is only three-fourths of our Nation at war? Why should the other 25 percent not share their just burden? Why should the people in Harlem pay this tax while those in the TVA area are tax free?

Today's Federal tax laws encourage discrimination by the Federal Government against the investor-owned tax-paying electric power companies because of the tax exemption granted to Government operated or Government subsidized electric power operations?

We urge that your committee explore the desirability of eliminating this favored tax treatment by equating the public power agencies with the investor-owned companies by levying the same taxes on those agencies as are extracted from the investor-owned utility companies. This could most readily be done by levying a Federal sales tax on the tax-free electric enterprises in proportion to the amount all Federal taxes of the investor-owned tax-paying companies bear to their gross income.

Studies have been conducted to determine the costs of tax favoritism accorded public power agencies. The reports of the studies indicate that the Federal Government would have received at least $3.6 billion over the period from 1954 through 1964, if the electricity had been sold by the tax-paying investor-owned utility companies.

These studies have also considered what the costs of such tax favoritism will be in the future. The estimates are that more than $7 billions would accrue to the Federal Government over the next 11 years if the electricity generated by the public power authorities were to bear its fair share of taxation in the same manner as the investor-owned companies.

Statement of Richard W. Lindholm, Professor of Finance and Dean of the School of Business Administration, University of Oregon, Eugene, Oreg.

Adaptation of Tax Policy to International and Great Society Requirements

The United States in 1966 is domestically utilizing its full production capacity and to carry forward this level of domestic economic activity demands large quantites of foreign imports of goods and services. It is also a society that is in the process of making a complete commitment to provide all residents with as much education as they can utilize, adequate medical attention and housing and a general minimum scale of living to everyone. The Federal Government's tax system is required to carry a large portion of this burden. Also, it is a tax system that receives some 85 percent of its revenues from taxes levied on profits and personal income.

The analyses of this discussion concern themselves with the appropriateness of this type of Federal revenue system under existing and evolving conditions. In developing the understandings considered appropriate, considerable attention is given to the tax systems of the member states of the European Economic Community (EEC). These tax systems have met the test of a fully utilized domestic economy and a broadly conceived social security program.

Traditionally, the member states of the European Economic Community (EEC) have made considerably greater use of indirect taxes than the United States, and much greater use of nonretail taxes measured by the sales price of things and services. These taxes are rebated on exports and are collected as compensatory border taxes on imports. This became accepted practice when tax rates were much lower than in the 1960's and has been included in the General Agreement on Tariff and Trade (GATT). This same technique for treating foreign trade was extended to the value-added tax developed by France during the past 10 years. Traditional treatment and the provisions of GATT do not permit similar treatment of direct taxes; i.e., corporate and individual income taxes.

The impact on the balance of international payments of tax differences is not in the relative level of taxation but in the types of taxes used to raise this level of Government revenue and the direction in which national tax systems are evolving.

The United States in financing its expanded social security program is relying on direct taxes as a precent of wages or in some cases other income, up to a designated level. This is also the general financing procedure utilized by the EEC member states in financing their social security programs. However in the case of EEC member states, taxes measured by income are not used as intensively in meeting general revenue requirements as in the United States. For example, individual income taxes as percentage of total tax revenue of central governments in 1961 was 11 percent in France, 22 percent in Germany and less than 10 percent in Italy. In the United States the percentage was 45.

The United States in expanding its social security program is placing additional burdens on a tax base already overburdened, in a comparative international sense. The situation arising from Federal and State use of income as the base for social security taxation at increasing rates and the related expenditure developments point to a need to reexamine the emphasis placed on income and profit taxes by the Federal Government.

Where Government expenditures are poverty elimination and social security provision oriented, the method of tax collection can concentrate much more completely on development of the economic base than in a situation where taxes are expected to perform some of the basic social justice tasks. The United States is now moving into the social justice area of spending at a rapid rate and this makes appropriate consideration of the introduction of a basically new philosophy of Federal taxation; i.e., the general philosophy of EEC member states. It is also true that the Federal individual income tax has not developed into the instrument of economic reform and income redistribution feared by its opponents and expected by its advocates. Rather the tax is a politically acceptable and administratively workable method of gathering together large revenues for use by the Federal Government.

The aim or goal of the Treasury in 1962 and again in 1965 was to amend the Internal Revenue Code so that tax neutrality exists between a decision whether to make a foreign or domestic investment from U.S. funds or foreign funds controlled by an American firm or individual. The legislation resulting from this effort, plus the regulations aimed at making the legislation effective, demonstrate that meaningful neutrality is very difficult to attain under conditions where the American tax system is very different from that existing in alternative investment, production, and capital reserve holding nations.

The basic Treasury argument for tax neutrality between foreign and domestic use of American-controlled funds has not been tax justice. The emphasized premise for the recommended change was an improvement in the U.S. balance of payments and a strengthening of the American economy.

The EEC is now deeply involved in carrying out article 99 of the Treaty of Rome. On April 5, 1960, under the provision of article 99, the EEC Commission established a Fiscal and Financial Committee (FFC) to work toward "establishment of a common market through creating and insuring conditions similar to those of an internal market" in the area of taxation. The report of the FFC was completed in July 1962, and adopted by the Economic and Social Committee of EEC on July 2, 1963, and by the European Parliament on October 17, 1963. Further details were agreed upon in April 1965 and, in October 1965, the Finance Ministers of EEC, meeting without France, decided that tax frontiers must be removed and that before July 1, 1966, turnover taxation harmonization should be well on its way.[1]

A substantial portion of the FFC report is a recommendation for a common EEC value-added tax along the lines of the very successful French taxe sur

[1] Tax News Service, International Bureau of Fiscal Documentation, Dec. 15, 1965.

la valeur ajoutie (TVA). The timing provides for passing and promulgating a common TVA system before December 31, 1967, and the entry of the system into force cannot be delayed beyond December 31, 1969.

EEC is well on its way to establishing a common TVA tax which under the rules of GATT possesses the capability of providing a powerful export stimulus through the rebate to the exporter of all TVA tax attributable to the production of the product exported. In France today this can mean a payment to the exporter of a good of 25 percent of the domestic price. It also can be the basis for restricting imports as the full rate of the tax can be applied to imports at the border, which in France could be 25 percent of price after adding French customs. It is very doubtful if a tax possessing these international trade "advantages" under accepted international rules can be abandoned or turned down by other nations once introduced and used by a major trading nation as a principal revenue source.

The acceptance of TVA by GATT as an indirect tax seems to have developed originally from the conditions out of which it arose and the method of French administration. The correctness of this decision can be the subject of an honest difference of opinion. But this is all water over the dam, and TVA, and therefore value-added taxes, are considered to be indirect taxes by GATT under article XVI–4 and implementing amendments. This GATT position combined with the proven effectiveness of value-added taxation points to a very nearly inevitable spread of the use of the tax. It can be a major revenue raiser with relatively low rates, as it is a multilevel tax. It can be the basis for a major tax refund to the exporter of goods and the levy of an equally substantial border tax. The attraction of value-added taxation to EEC member states as a substitute for their cascade turnover taxes is nearly irresistible, for the tax does not violate the basic theory of turnover taxation while it eliminates most of the weaknesses of this tax.

The value-added tax device has proven itself in France. The generalization of the procedure will permit EEC member states and other Western European nations to continue, and to relatively increase the portion of total government revenues arising from a multilevel transactions tax. This development will relieve the revenue pressure for substantial corporate and individual income taxes. More than likely value-added taxation will also make it politically easier to retain general indirect taxation as the major revenue raiser. The net effect will be that pressures for European use of direct taxation will decrease and pressures against indirect taxation, particularly of the multistag type, will also decrease. This in turn will permit more generous treatment of profits and incomes under the direct tax rates of EEC member states.

A number of results with worldwide impacts can be associated with this tax situation. (1) It makes it more difficult for the United States to enjoy its economic potential. (2) It causes the rebirth and continuation of international economic barriers. (3) Free world liquidity may be reduced because the U.S. competitiveness will be reduced and this will increase foreign reluctance to hold dollars, increasing the possibility of financial crisis.

United States international payments difficulties set into motion by tax disharmony cause the following chain of events:

The lower profits taxes in the EEC member states than in the United States make it attractive for American capitalists to invest in the EEC and to retain reserves outside of the United States and for EEC capitalists to refrain from investing in the United States—causing negative international balances on capital accounts.

The tax refund available to exporters from EEC member states, but not available to exporters from the United States, and the border taxes assessed by EEC, but not by the United States, will combine to reduce U.S. international balances on trade accounts.

The United States, by shifting its national tax system toward the existing and evolving tax system of EEC member states, can escape the "national tax disharmony syndrome." But this is not the only possible escape route. The United States could devalue the dollar, or withdraw from GATT and freely change its tariffs to compensate for border taxes and tax refunds, or severely restrict foreign investment of American savings. However, the alternatives to moving toward tax harmonization are not attractive.

The Europeans and particularly the EEC member states also have alternatives: They could revalue their monetary units upward relative to the American dollar. They could abandon the trade advantages possessed by indirect taxes. They could collect profit and income taxes equal to the U.S. level. They could prohibit foreign investments in their country. Some of the alternatives possess the same basic unattractiveness of causing a further reduction of freedom in international transactions as do the U.S. alternatives. Others run counter to the basic competitive nature of international transactions between national groupings.

The alternatives to a basic harmonization of the U.S. tax system with the system existing and evolving among the EEC member states show few of the characteristics required for acceptability. Meanwhile during the past 4 years the U.S. tax system has been rather continuously moving toward harmonization with the European concept of a proper tax system. The changes appear to have been good for the United States. At the same time the Europeans in the value-added tax have developed a technique for making much more effective use of their concept that the transaction should be an important tax base. With the exception of some United Kingdom tax developments, the last 4 years have not been a period in which European taxes have been moving toward the American model of high profit and income tax rates.

A very reasonable conclusion to draw from this analysis is that international economic freedom and free world economic growth would be well served by a basic change of the American tax system toward the existing and evolving EEC model. This would require a substantial reduction in the portion of U.S. Federal Government receipts arising from direct taxes and an increase in the portion arising from indirect taxes. To do this would more than likely involve legislation providing for the gradual introduction of a national value-added tax and to the exemption of low- and middle-bracket-income receivers from the individual income tax, plus a sharp reduction of the corporate income tax on all distributed corporate profits.

The discussions that took place when the U.S. 1962 Revenue Act was before Congress and in the Summer of 1965 in consideration of H.R. 5912 which dealt with treatment of foreign investors by the U.S. tax system, demonstrate that the tax differences between the United States and Europe are sufficiently sharp to warrant new U.S. legislation. The American tax legislation recommended by the Treasury and adopted by Congress has not been aimed at a general harmonizing of the American tax system with the tax system existing and evolving in Europe, except in an incidental way, as was pointed out above. The aim has been to develop procedures to prevent the differences in the prevailing tax systems from placing an unbearable strain on the U.S. balance of international payments under current conditions. It is questionable if this is the best method of meeting the long-term requirements for the development of the American economic potential and the economic growth of Europe and the world. It is a slow and laborious method for harmonizing the U.S. tax system with the existing and evolving tax systems of EEC member states.

It is also true that a movement toward the taxation of sales, more than likely utilizing the value-added approach, is appropriate in a society guaranteeing minimum living standards and unlimited education opportunities. Narrow base taxes or taxes with a large income redistribution aim and a tax system relying nearly exclusively on direct taxes have become very nearly an anachronism.

True the situation today with the Vietnamese war is an exaggerated prototype of the U.S. society as it is evolving. Under conditions of less stress, the U.S. producer would find exporting more lucrative and tax refunds would not be so necessary to cause him to look at his international opportunities. However, he would also find foreign investment more attractive when domestic markets were weaker. The conclusion must be that under normal or current conditions our tax system causes balance-of-payments difficulties.

The Great Society and its attended expenditures is basically an additional step in the development of the U.S. social security program. It gives the U.S. resident the health protection long enjoyed in the EEC member states and expands income guarantee coverage of the aged and the economically weak, which has also been provided generally in Western Europe. The U.S. provision of education goes considerably beyond the European experience. This is in the American tradition.

This type of an expenditure program destroys the basic support for a tax system that attempts to collect nearly all of its taxes according to ability to pay as measured by very complicated legislative definitions of taxable income of the corporation or the individual.

The comparative international impacts of the existing U.S. tax system, the movement toward citizen income guarantee and service provision Federal expenditures combine to support a U.S. tax system making use of a broad expenditure tax base as well as the income base.

Statement of Philip Savy, President, American Metal-Lux, Inc., Hartford, Conn.

One aspect of the current economic contingency which appears to have been overlooked by witnesses at the committees' inquiry, concerns the inadequacy of capital formation over the years which has now reached the critical point.

The interest rates, which are the measure of the supply and demand in the capital market and are now at a peak, have been steadily increasing for years, not just now, thus indicating all along a growing scarcity of the supply vs. the demand for capital. Incidentally, this fact is confirmed by a statistical study made by Professor Kuznets of New York University for the National Bureau of Economic Research.

Concurrently, the rapid and sizable wage increases of recent years, have expanded the national purchasing power and closed the gap of unemployment. This means that, particularly within the last 18 months, the economy, already under chronic strain, has been called upon to equip for work some 2 million newly absorbed workers.

As it takes about $20,000 capital investment for each new job, the economy has experienced a sudden demand for capital of about $40 billion, over and above the normal yearly requirements and is now still struggling with that momentous demand.

Therefore, the mounting upward pressure on interest rates at this time reflects nothing but the critical situation created by this rapid reabsorption of workers, and points to a need for more capital, not less.

Moreover, starting with the coming fall season, the new crop of youngsters born after World War II will enter the labor market at the swollen rate of nearly 2 million, that is, more than double the previous rate. This increase alone, will require an additional capital investment of over $20 billion per year or thereabout. Whether or not these new workers entering the labor market will find a job, will depend in great measure upon the action taken by the Congress at this time.

It is clear that the present crisis is not a transient phenomenon, but the culmination of a longstanding deficiency in our economy which needs closer consideration and a permanent solution. As for the present emergency, it is also clear that any restraining measure directly or indirectly affecting capital formation, would only aggravate the crisis. And please note that I am speaking as a financial and economic analyst and not as a businessman.

This statement is intended only to touch the surface of an obviously complex side of the present economic problem.

Statement by Martin Schnitzer, Professor of Economics, Virginia Polytechnic Institute

The recent hearings of the Subcommittee on Fiscal Policy of the Joint Economic Committee focused on three topics: contributions of rapid tax changes to stabilization, criteria for such tax changes, and technical design. A statement concerning the first topic is therefore submitted to the subcommittee.

Fiscal policy is important as a device for economic stabilization. Changes in taxation and Government spending can influence output ond employment. As a countercyclical measure the automatic stabilizers—the personal income tax, unemployment compensation, et al.—have been proved successful. Direct changes via legislative enactment—the tax cut of 1964 and the investment credit of 1962—have also demonstrated the effectiveness of fiscal policy.

However, fiscal policy to be effective, must work two ways: as a stabilizing device during both periods of unemployment and declining output, and during periods of full employment and rising prices. Reduction in taxes, increases in Government expenditures, or both, can compensate for a lack of total aggregate demand during unemployment; increases in taxes, reductions in Government expenditures, or both, can offset too much demand during an inflationary period.

Against the context of the current economic situation, it is apparent that some form of a tax increase should be considered. The proper tax instruments that should be considered are those that will affect consumption and those that will affect investment. Consumption will be affected by a change in the personal income tax; investment by a change in the corporate income tax or the elimination of the investment credit. The change selected is bound to have some effect on individuals and business firms.

The remainder of the statement is devoted to an examination of tax measures designed to influence consumption and investments and to policy recommendations concerning taxes.

MEASURES DESIGNED TO AFFECT CONSUMPTION

The personal income tax is the appropriate vehicle through which immediate changes in disposable income can be effected. Subject to legislative approval, changes in tax rates can be put into effect through the withholding aspect of the income tax. An increase in the personal income tax rates will result in lower consumer disposable income. Lower incomes will reduce consumer demand with a concomitant effect also on investment demand.

The increase in rates can be designed in several ways which are as follows:

1. A standard point change in each income bracket.
2. An equal percentage change in individual tax rates.
3. A change in the rate equal to a standard percentage of disposable income.

The choice of the appropriate technique to use should depend on equity standards as well as effectiveness in reducing consumer purchasing power. A tax credit could be given to those persons who are in the lowest income brackets.

Since the personal income tax is a broadly based tax, it is probably best suited to countercyclical fiscal policy. Consumer spending accounts for approximately two-thirds of the total volume of expenditures in the economy. Reductions or increases in consumer spending through changes in the personal income tax can be accomplished without any serious timelags.

MEASURES DESIGNED TO AFFECT INVESTMENT

Several devices have been used by the United States and other countries to affect the investment component of gross national product. These devices include the investment tax credit, accelerated depreciation, direct taxes on investment, the use of investment reserves, and changes in the corporate income tax rate. All lend themselves to countercyclical manipulation.

The investment credit tax was provided in the Revenue Act of 1962 as a device for stimulating investment in machinery and equipment. The rationale for the credit was to stimulate investment for the benefit of the entire economy. The unemployment rate at that time was well above 5 percent, and the Kennedy adminisration felt that measures to stimulate aggregate demand coupled with measures to correct regional imbalances—area redevelopment, public works—were necessary to reduce the rate of unemployment and stimulate economic growth.

By current economic standards, it would appear logical that the need for some of the above measures should be reexamined. The investment credit, by stimulating investment particularly in marginal capital acquisitions, adds fuel to an already inflationary potential which exists in an economy which at present has the lowest unemployment rate in more than a decade. It could well be eliminated, at least for the present.

However, the elimination of the investment credit may pose several problems which are as follows:

1. Although the elimination of the investment credit may accomplish a short-term objective—a reduction of the potential for inflation—a longrun problem may also occur. Presumably, business firms may be more reluctant in the future when the investment credit is again permissible to undertake investment. An element of uncertainty has been introduced. Will certain investments be undertaken, when firms remember full well that the credit was taken away from them previously?
2. What happens to investment that is currently being undertaken? Presumably elimination of the investment credit would not apply to investment under contract. However, a timing problem is apparent—by the time the repeal of the credit is felt, the economy may no longer be affected by inflationary pressures.

The investment tax has been used in Sweden several times in the last decade when inflationary pressures were prevalent in the Swedish economy. The tax amounted to a rate of 10 to 12 percent on capital expenditures—in particular expenditures for machinery, new or used, with an anticipated life of more than

3 years, and expenditures for new buildings, or for the remodeling, rebuilding, or expansion of existing buildings. The tax was levied on the sum total of taxable investment for the year less a fixed exemption. The tax was deductible for purposes of both the national and local income taxes. In 1957, the last year the tax was used, it raised 201,699.600 kronor ($39 million) based on total taxable investment expenditures of 1,681 million kronor ($300 million).

Sweden, Denmark, and Finland currently use a countercyclical fiscal device which, if nothing else, is unique in its arrangement. Business firms are encouraged to set aside annually a certain percentage of pretax profits in an investment reserve. The amount is deposited in a blocked account in the Central Bank and is to be released when the economy needs stimulation. The reserve is exempt from the corporate income tax as long as it is used in the prescribed manner. Other tax advantages accrue upon release of the reserves.

In Sweden, the normal procedure has been to permit firms to set aside up to a maximum of 40 percent of pretax profits in an investment reserve. Forty-six percent of this reserve has to be deposited in the Central Bank of Sweden, and the firm may utilize the remainder. The portion of the reserve in the Central Bank is released to the firm to be invested along with the remainder when unemployment becomes a problem.

In 1960 and 1961, when the Swedish economy suffered from heavy inflationary pressures, business firms were offered more favorable tax advantages if they deposited the total investment reserve (100 percent instead of 46 percent) in the Central Bank. Approximately 1 billion kronor were deposited during the last two quarters of 1960 and the first quarter of 1961.

Although the investment reserve has worked successfully in Sweden, it is extremely doubtful that as a selective fiscal device it can be transplanted in the United States. Institutional differences are too great to make meaningful comparisons.

Accelerated depreciation has also been used as a countercyclical fiscal device by Great Britain with some success. This device has also been used by Canada and West Germany. To work as a countercyclical fiscal instrument, depreciation allowances are raised during periods of lower economic activity so as to encourage investment, and lowered during periods of prosperity to retard investment. However, as a fiscal policy instrument, accelerated depreciation would be subject to some of the same problems that confront the use of the investment credit.

CONCLUSIONS

For countercyclical fiscal policy to be effective, consistency is necessary. If taxes are lowered to stimulate consumption and investment during a period of unemployment, they should be raised during an inflationary period to reduce aggregate demand. The same would hold true for Government expenditures—raise during a period of unemployment and lower when excess aggregate demand exists. Unfortunately, this prescription is much more palatable during a period of unemployment than during an inflationary period. Government expenditures are easier to increase than reduce; taxes are easier to reduce than increase.

It is apparent that some rather unpalatable choices may have to be made. The personal income tax could be raised, the corporate income tax also, or the investment credit eliminated. Serious opposition can develop to each choice; nevertheless, the choice has to be made. Therefore, the most acceptable choice would be repeal of the investment credit.

STATEMENT BY CHARLES STEWART, PRESIDENT, MACHINERY AND ALLIED PRODUCTS INSTITUTE AND COUNCIL FOR TECHNOLOGICAL ADVANCEMENT, WASHINGTON, D.C.

THE INVESTMENT CREDIT—THE CASE FOR ITS PERMANENCY

Our comments will be directed to the role of the investment credit in the economy and to a consideration of its appropriateness as a countercyclical device. The reason for this concentration is threefold:

1. We believe the investment tax credit as applicable to productive equipment was an imaginative and sound proposal. Further, we believe the credit has worked and has proven its merits as a permanent part of our tax structure.

2. The investment credit is the subject of one of the recommendations of the full Joint Economic Committee in its 1966 Joint Economic Report. To wit:

"We should immediately suspend the 7-percent investment credit provision in view of the extraordinary exuberance indicated by investment programs. This is one of the major inflationary threats of this year. This action should be accompanied by a provision that the 7-percent credit would go back into effect at a fixed future date unless Congress acts to extend the suspension."

3. As a national organization representing the capital goods and allied equipment industries, the institute speaks on behalf of firms who have the unusual vantage point of being at one and the same time both the producers and major users of the productive equipment subject to the investment tax credit. This vantage point also includes familiarity with the impact of the credit on the wide range of customer industries served by capital goods producers. Finally, from the original conception of the credit, the institute has studied it closely.

We turn first to a brief discussion of the investment credit in relation to the goals of our economy.

Goals—One theme with different arrangements

After 20 years under the Employment Act of 1946 its goals of "maximum employment, production, and purchasing power" have come to be generally interpreted as full employment, economic growth, price stability, and balance-of-payments equilibrium. Since it is impossible to maximize everything at once—and since conditions change as well—the individual goals have been given different priorities at different times. Currently, the goal of stability is receiving the most attention and, because of this, there is a strong tendency to analyze and pass judgment upon a particular measure only in terms of its contribution (or lack of it) to this one goal. We make two observations in this connection:

1. There is a great danger that in attempting to avoid inflation and maximize price stability we will sacrifice the progress we have made in achieving present levels of full employment, economic growth, and balance-of-payments equilibrium.

2. The investment credit has played—and can continue to play—a major role in achieving the essential economic goals of full employment, economic growth, and balance-of-payments equilibrium. Further, it is not without merit in its contribution to reasonable price stability as well.

The positive role of the investment credit

The rationale of the credit.—In the current dialog on the investment credit it is frequently overlooked that there was a basic and longrun consideration in enacting the investment credit upon the recommendation of President Kennedy. This was brought out at the time by then Secretary of the Treasury Dillon in testimony before the House Ways and Means Committee: [1]

"As we look back over the past century we see that our record of economic growth has been unmatched anywhere in the world. But of late we have fallen behind * * *. In the last 5 years Western Europe has grown at double or triple our recent rate and Japan has grown even faster. While there is some debate as to the precise annual growth rate of the Soviet economy, CIA estimates that their GNP grew at a rate of 7 percent in the fifties. Clearly, we must improve our performance, otherwise we cannot maintain our national aspirations. The pressing task before us, then, is to restore the vigor of our economy and to return to our traditionally high rate of economic expansion and growth. I am confident this can be accomplished. But it will require a major effort by all of us.

"I have been impressed during recent travels abroad by the great progress our friends overseas have made in reconstructing their economies since World War II and by the highly modern and efficient plants they now have at their disposal * * *. All the information we have indicates that their plant and equipment are considerably younger than ours. Although this difference reflects the rebuilding of the shattered European economies. I think it is important to emphasize that it was due in good part to the vigorous policies of the European governments. Tax incentives for investment played a significant role, including accelerated depreciation, initial allowances, and investment credits."

This same point was made even more directly in the statement of the Council of Economic Advisers before the Joint Economic Committee: [2]

[1] "President's 1961 Tax Recommendations," 87th Cong., 1st sess., May 3, 1961, pp. 21, 22.

[2] "The American Economy in 1961: Problems and Policies," Mar. 6, 1961, p. 49.

"Measures to stimulate business investment directly will contribute to our recovery from the present recession, but that is not their main purpose. All who have confidence in the American economy must look ahead to the day when the slack will be taken up and high levels of output and employment will again be the rule. The full benefit of our decision to supplement increases in consumer demand now with a higher rate of capital expansion and modernization will then be realized."

The message is clear. There are longrun advantages to the investment credit for productive equipment that outweigh any use it might have as a device to offset cyclical changes in the economy. What are these advantages?

The case for the credit.—In essence, the investment tax credit is vital to economic health in that it provides an incentive to continued growth of the Nation's producive capacity and the modernization and replacement of its existing equipment. In so doing it provides the assurance the economy can:

1. Provide the goods necessary to meet its domestic needs—civilian and defense—and, in so doing, combat inflation;
2. Provide the additional jobs and equipment required by an expanding labor force;[3]
3. Enable the economy to provide wage increases in accordance with productivity without inducing price increases;
4. Fulfill our international obligations; and
5. Meet the competition for world markets and thus contribute to the solution of our balance-of-payments problem.

To make its proper contributions to the performance of these tasks, the investment credit should be—as it was originally considered to be—a permanent part of our tax structure. To convert the credit to meet the requirements of a countercyclical tool—i.e., that it be used on an on-again, off-again basis—would run the risk of sacrificing its effectiveness in fulfilling the vital goals for which it is uniquely designed. But even assuming that serious consideration should be given to its use as a countercyclical tool, how will the credit function in that role?

The credit as a countercyclical tool

It is generally agreed that the criteria that should be met by any tax used as a countercyclical tool include the following: (1) It must be promptly effective and its economic results consistent with desired effects; (2) it must be equitable; and (3) it must not create uncertaintly in business planning, investment, and output. We conclude that the investment tax credit fails on all three grounds and as we understand Assistant Secretary of the Treasury Surrey's testimony before this subcommittee on March 30, he makes the same judgment.

Delayed effects.—Under present circumstances, there is an average lag of 9 or 10 months between the go-ahead decision (appropriation or authorization) and the installation[4] of credit-eligible equipment.

This means that the major part of the equipment to be installed during the remainder of 1966 is already in the pipeline. Denial of the credit at this juncture might have some effect on projects authorized but not yet committed, but it would not affect significantly those already on order. It follows that the restrictive effect on capital goods activity would be largely deferred. Most of it would come in 1967.[5]

Perverse reactions on suspension.—Unless the effective date of the credit suspension is definitely and convincingly in the past, the legislative consideration of the proposal will trigger a frantic rush to obtain deliveries of credit-

[3] Capital Goods Review No. 61, "Labor Force Growth and Business Capital Formation," MAPI, March 1965.

[4] Note the significance of the "installation" test under the investment tax credit provisions. As Assistant Secretary Surrey said, "Actually, I think people who have advocated suspension of the credit really have an image of its operation that would have it turn on orders rather than installations as it now does. This possibility was explored at the time the credit was originally set up and found not to be feasible."

[5] Senator William Proxmire made this same point in his supplementary views in the "1966 Joint Economic Report" at p. 23: "Because there is a considerable 'leadtime' in carrying out investment projects; because the investment credit becomes available when assets are put in service and hence present contracts are being undertaken in reliance on the availability of the credit when the project is completed; because suspension of the credit would have to provide an exception for projects already under commitment, but which will be completed in the future; it follows that suspension of the investment credit would generally not alter investment expenditures or tax revenues for a substantial period of time."

eligible equipment before the deadline. This will aggravate the pressure on the equipment producer that it is the object of the suspension to abate.

It appears to be the view of leading proponents of suspension that equipment orders outstanding at the time of suspension must necessarily be exempt from its application on grounds of equity. In this case, the legislative consideration of the proposal—unless again the cut-in date is convincingly in the past—would lead to an orders stampede. This might not be as harmful as a deliveries stampede, but it could be very disturbing to capital goods suppliers, and is certainly not calculated to relieve the pressure on them in the near term.

Perverse reactions on restoration.—If the restoration of the credit were either dated in advance or anticipated by industry, it would obviously provide a powerful inducement for the deferment of new equipment installations until after the deadline. If the restoration applied to orders placed after the deadline, it would have an even more retarding effect. On either basis, the arrangement would produce an artificial depression in capital goods markets at the wrong time and contrary to the intention of its sponsors.

Timelines.—In view of the delayed impact of a credit suspension on capital goods activity, the question arises whether the move is timely. There are powerful forces of restraint already at work in this area—falling corporate liquidity, increased pressure on internally generated funds, reduced credit availability and higher interest rates, rising costs of capital projects, severe shortages in skilled manpower, etc.—and there is informed opinion that the peak of new authorizations has already been reached. If this is correct, the effect of suspension—especially if delayed for 2 or 3 months—would come too late to be of much value. It would have its chief impact after the squeeze is over, and would aggravate any subsequent correction.

Inequity.—In addition to the problem of long "leadtimes" mentioned above, capital expenditures also involve a good deal of preplanning and preparatory expenditures for such items as plant design, engineering work, etc. Any removal of the credit forcing a change in plans obviously results in certain losses or penalties to the company. Further, many such commitments are not only planned long in advance, but are contracted for. Where this is the case a change in plans is no longer feasible and this raises questions of the Government's keeping good faith with the taxpayer.

There is another matter of equity that merits attention here. The credit is a vital and necessary part of our tax system as long as industry is subject to the present extremely high corporate rates which have such a penalizing effect on investment.[6]

Uncertainty.—Frequent reversals of tax policy tend to destroy incentives. Under such conditions there is a reluctance to make capital expenditures when there is uncertainty as to the character and timing of congressional action. This is an important consideration at a time when industry is increasingly engaging in long-range planning and that planning with respect to expenditures on production equipment takes the investment credit into consideration. Thus, to the extent that the investment credit becomes an on-and-off device its usefulness will be severely impaired.

Summary.—The moral is clear. The investment credit, potent as it is as a device to support and facilitate capital investment, does not lend itself readily to manipulative application because of its inherent limitations as a countercyclical tool.

The crucial element of timing

The proper tools.—Unquestionably. the practice of economics has become more sophisticated in recent years. We believe that through the efforts of economists in Government. academe, and industry we know a great deal more about the economy and we are hopefully that Government itself has become somewhat more astute and sophisticated in the use of economic tools. However, at this time it must be admitted that there still remains a good deal to be done in improving our analytical techniques and until this is accomplished we are not in a position to proceed with a great deal of reliability into the niceties of countercyclical fiscal policy.

Where are we now?—There are some who believe that the forces of inflation are severe and will grow much worse. There are others, with whom we

[6] "Effect of Corporate Income Tax on Investment," George Terborgh, Machinery and Allied Products Institute, March 1959.

are inclined to join ourselves, who feel that although there are some significant inflationary signs, it is unlikely that we confront a runaway situation; indeed, it is very likely that we are near the top of the cycle and may be leveling off. As noted above, there are powerful forces of restraint already at work. These include the tight money situation both as to availability and rates, declining profit margins, and the decline in common stock prices in heavy trading. In terms of capital expenditures, this does not necessarily mean that we are about to face a recession, but rather a significantly slower rate of growth in physical output and a growth rate in plant and equipment expenditures closer to that of the economy as a whole.

Forces at work.—In addition to the "straws in the wind" we have mentioned, there are a number of basic forces at work which will increasingly exert a restraining hand on the economy. President Johnson himself has identified these factors. These of course include the Tax Adjustment Act of 1966 which it is estimated will raise $6 billion in Federal revenue over the next 15 months, the increase in social security and medicare taxes of some $6 billion at annual rates which went into effect on January 1, 1966, and the recent action of the Federal Reserve Board in raising the discount rate. In addition, it must not be overlooked that Congress can, and we think should, assert a firmer control over Federal expenditures and the executive department has leeway in certain of its actual spending decisions.

Beyond these factors, there is one other that to our knowledge has been overlooked by commentators on this subject; namely, the fading boom in corporate tax depreciation. Since the institute has documented this at length elsewhere[7] we will simply excerpt the relevant portion of the conclusion of that study:

"The great postwar surge of corporate tax depreciation is over. From now on, the increase in accruals will be more closely geared to the longrun growth trend of corporate capital expenditures.

"There is considerable reason to believe, moreover, that the rate of increase will actually fall below this growth trend. The future of corporate capital expenditures is of course unpredictable, but if they rise over the next decade at the average rate of the past 15 years (about 5.5 percent per annum), a shortfall of depreciation growth seems probable. The probability arises principally from the prospective fadeout of the relative net benefits from the accelerated writeoff methods of the 1954 code and from the guideline life system."

Summary.—In light of the "margin of error" that exists in the application of macroeconomics, the relatively crude state of our analytical tools at this time, and the forces for restraint that have yet to reach their full potential, it would appear precipitous to take action to suspend the investment credit at this time on these grounds alone.

Summary and conclusion

The investment tax credit was enacted by the Congress upon recommendation by the Kennedy administration in order to stimulate sound capital investment as a means of both increasing our rate of economic growth and making U.S. industry more efficient and thus more competitive at home and abroad. It was later liberalized in the same spirit. The objectives of the act are just as vital today as when the law was enacted despite some changes in economic conditions.

When the investment credit was proposed and enacted it was in the spirit of permanency. There is a clear legislative record to this effect. To attempt to use the credit as purely a countercyclical tool on an in-and-out basis would be a breach of faith, in addition to interfering with the longer range goals to which it is addressed.

Most persuasive in terms of the applicability of the credit as a countercyclical device is that it simply would not be effective. The credit is not well suited to such use both because of the cut-out and cut-in problem and the fact that it will lead to perverse reactions due to the effect of anticipated changes in the credit on the behavior of industry.

Frequently the arguments in favor of suspending the investment credit seem to assume that success or failure in the fight against inflation turns on this single proposal. This obviously is not the case. The Tax Adjustment Act of 1966, the increase in social security and medicare taxes which went into effect

[7] "The Fading Boom in Corporate Tax Depreciation," George Terborgh, Machinery and Allied Products Institute, 1965.

in January of this year, and the recent action of the Federal Reserve Board in raising the discount rate all have a restraining effect—both directly and indirectly—on capital expenditures and have not yet attained their potential impact. In addition, the supply of corporate funds will be adversely affected by the passing of the postwar boom in corporate tax depreciation, and the prospect of a deteriorating relation between capital requirements and financial availabilities.

The great economic challenge to the United States today remains the achievement and maintenance of the most modern technology and industrial plant in the world. It is only in this way that we can conserve the progress we have made, protect our national security and our international competitive position, and insure the highest level of job creation.

This concludes our comments on the role of the investment credit in the economy and its appropriateness as a countercyclical device both in the current economic context and as a general principle.

STATEMENT BY NORMAN B. TURE,* NATIONAL BUREAU OF ECONOMIC RESEARCH

The hearings by the subcommittee on fiscal policy on prompt tax changes for economic stabilization reflect the Joint Economic Committee's long-standing interest in public policy measures to improve the performance of the U.S. economy. The widespread concern with standby fiscal measures which can be put into action promptly to curb recessionary and inflationary developments reflects a wholesome desire to improve the machinery of public economic policy for attaining objectives of the Employment Act of 1946. The objective of a more stable economy sought in proposals for prompt implementation of countercyclical tax changes surely warrants approval. I believe, however, that these proposals are based on a misconstruction of the reasons why effective discretionary fiscal action to moderate or prevent short-term departures from stability conditions are not taken on a timely basis.[1]

Basically, the aim of the proposed measures is to get counteracting tax action into effect before recessionary or inflationary developments are well underway. If these measures are to succeed in this purpose, they must be based on a correct identification of, and must deal effectively with, the factors which may impede timely action.

First, in point of time, among the factors which may preclude timely tax action against recession or inflation is tardy recognition of the need for such action. The recognition lag may arise because the signals of recession or inflation are not strong enough or because there is disagreement as to their meaning or because attention is focused on indicators which are themselves late messages. Secondly, there may be a lag between recognition of the occasion for compensatory measures and their enactment. This lag may reflect disagreement among policymakers with regard to the priority to be given policy objectives which may appear at the time to be in conflict with each other. There may be, for example, agreement that economic developments portend inflationary strains but disagreement as to the desirability of anti-inflationary action in view of the check on improvement in employment conditions which might result. The lag between recognition and action may also stem from policymaker's disagreements about the type and extent of action to be taken, even after a consensus has been achieved regarding policy objectives. If compensatory action is substantially delayed, whether because of the recognition lag or because of tardy agreement about the kind and amount of action to take, efforts to stabilize conceivably could contribute to instability, particularly if the speed with which compensatory measures take effect is overestimated.[2]

These factors have operated at one time or another in the postwar years to impede timely countercyclical tax action. Without here detailing the record, I conclude that it was only on the occasion of the outbreak of the Korean war that

*The views expressed herein are my own and are not to be construed as a report of findings or conclusions of the National Bureau of Economic Research, Inc.

[1] If the problem requiring compensatory fiscal action is persistent underutilization of the Nation's production capabilities or persistent inflationary conditions, there need be much less urgency attached to the speed of fiscal action.

[2] To repeat, these considerations have weight only in the case of short-term economic fluctuations.

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timely tax action was deliberately taken for the purpose of moderating the anticipated destabilizing development.[3]

Although each of these factors have been operative, an examination of the history of postwar stabilization policy, I believe, leads to the finding that the principal impediment to timely action is the recognition lag, not a sluggish response by the Congress once the need for quick action was presented. To enhance the possibilities of prompt stabilizing action, therefore, policy should be focused primarily on reducting this lag. In fact, however, most of the measures proposed for accelerating fiscal action against recession or inflation are concerned with reducing the second lag—that is, with reducing the time between recognition and initiation of action. This concern, I think, reflects a misplaced emphasis. Adopting measures to reduce this second lag, e.g., by giving the President standby authority to make temporary changes in tax rates, would contribute little toward more timely stabilization actions.

It is often assumed that the techniques of economic analysis have advanced to the stage where prompt recognition of the need for stabilizing action is no longer a problem. The postwar history of the American economy, however, affords little basis for confidence in this regard. For example, there have been four recessions since 1946; that of 1948–49 lasted 11 months, from November 1948 to October 1949; that of 1953–54 lasted 13 months, from July 1953 to August 1954; the 1957–58 recession lasted 9 months—from July 1957 to April 1958; and the 1960–61 recession went from May 1960 to February 1961, or 9 months (dates are those of the National Bureau of Economic Research, Inc.). In none of these instances was there timely recognition of the existence of the recession, at least as reflected in the public utterances of the individuals responsible for guiding public economic policy in such matters. Of course, it is difficult to know just when the President and his economic advisers have determined that significant changes in the conditions affecting employment, output, and the price level have occurred, and it may be that their recognition of these changes preceded by a substantial amount of time any such utterances. If the policy changes—or proposals for fiscal measures—in fact lagged behind recognition by only a short period of time, however, the record strongly suggests that policymakers and advisers in the executive branch and in the Congress have been quite tardy in realizing the need for anticyclical action.

The present situation illustrates very well indeed that it is delayed realization of the need for action, rather than delay in providing the measures requested by the President, which is the principal reason that timely action is not taken. The U.S. economy during the first quarter of calendar 1966 affords scattered but impressive evidence of the operation of inflationary pressures. These pressures did not arise overnight, however. If they were to have been prevented from materializing, offsetting public policy action should have been taken when the sources of these pressures were getting underway; i.e., for the most part in 1965. There were, however, no official utterances during most of 1965 dealing with the inflationary developments deriving from an excessively rapid expansion of aggergate demand, or major components thereof, nor was there any significant change in the direction of fiscal policy announced in 1965. It may be fairly inferred, therefore, that the strength of inflationary factors was not recognized during most of 1965.[4]

Two of the developments now widely identified as major sources of current inflationary strains are the rapid rise in defense expenditures and in business spending for new plant and equipment. The actual expenditures by business in 1966 for capital goods, however, is of little consequence in this connection. The expansionary effects of this increase in investment arose from the production of the additional plant and equipment and began shortly after orders were placed, for the most part in 1965 and prior years. The disbursement of funds by

[3] For a detailed examination of public policy responses to changes in broad economic aggregates calling for discretionary policy actions, see Wilfred Lewis, Jr., "Federal Fiscal Policy in the Postwar Recessions," the Brookings Institution (Washington: 1962), and Joint Economic Committee, "Staff Report on Employment Growth and Price Levels," ch. 8, "Fiscal Policy," Joint Committee Print, 86th Cong., 1st sess.

[4] Some economists had identified the broad fiscal and monetary developments of 1964 and 1965 as inflationary since these developments aimed at expanding aggregate demand in order to overcome unemployment whereas the more consequential limitations on the expansion of employment and real output were deemed to be structural factors. Such characterizations may prove to be correct, but are not properly construed as evidence of timely recognition of a specific cyclical swing. (See Arthur F. Burns, "The Management of Prosperity," Columbia University Press, 1965).

capital goods buying companies in 1966 is evidence primarily of the amount of additional production which has occurred and of itself is not expansionary, representing merely a transfer of liquidity among business firms. In a similar way, the increase in defense outlays this year is of much less consequence than the increase in defense orders last year in terms of effects on aggregate demand. Timely action to have curbed the rate of rise of investment (if that were indeed deemed to be the proper course of action) and to have compensated for the possibly inflationary effects on the economy of increases in defense demands would have required prompt recognition of the implications of the accelerated expansion of orders for capital goods and the step-up in Defense Department orders for hard goods. Prompt recognition might well have led to a prompt request for compensating action. But during much of 1965, to repeat, this recognition was not forthcoming. Indeed, the Federal Reserve's action in raising the discount rate in December 1965, an action which reflected the Fed's view that aggregate demand was expanding too rapidly, was widely identified as premature.

The purpose of these observations is not to fault the administration for failing to identify these sources of inflationary pressure as they emerged in 1965. A large amount of evidence during the year pointed to continuing gains in real output at a high rate with little change in price trends. Belated official recognition, rather, illustrates the contention that the evidence upon which a useful forecast of fiscal policy requirements must be based may cast up conflicting signals. Timely action nevertheless must rely on forecasting, however uneasily.

The importance of forecasting for timely fiscal action also may be illustrated by reference to the current situation. Had the effect on aggregate demand and the price level of increasing defense and business orders for hard goods (among other factors) been recognized early enough in 1965, countervailing tax (or expenditure) measures might have been requested to check the expansion in business orders for plant and equipment and/or to moderate the increase in consumption demand (the fact that such measures were not proposed can hardly be attributed to the President's lack of authority to make temporary tax changes, with or without subsequent ratification of this action by Congress). Tax increases are now being proposed on the basis of the current evidence of these past developments. Measures providing short cuts to tax changes have little relevance for present fiscal requirements: tax action today should be based on a forecast of likely developments over the next year or so; if such a forecast indicated the need for tax increases, there would be ample time under normal procedures to enact them. On the other hand, if such a forecast were to indicate a significant easing of inflationary strains, quick tax increases today might well contribute to bringing about a recession; they could not undo the developments of the past which today appear to be making for too rapid expansion of aggregate demand.

That the second lag—that between the determination of the need for compensatory tax changes and enactment of such measures—is not a major impediment to timely fiscal action is also illustrated by the present situation. The President delivered his 1967 budget message on January 24, 1966. In the message, he requested certain tax changes aimed at increasing administrative budget receipts in fiscal 1966 and 1967 in order to moderate the expansionary impact of Federal fiscal programs in those years. The Tax Adjustment Act of 1966, affording the requested changes, was signed by the President on March 15, 1966, just 50 days later. It is difficult to conceive the circumstances in which materially speedier action would make the difference between successful or unsuccessful countercyclical policy.

This experience suggests that if the President were to request additional tax changes to moderate short-term destabilizing movements, the Congress would respond with equal speed. This conclusion would hold, I believe, even if the requested tax changes were significantly sterner measures than those in the Tax Adjustment Act of 1966, provided that the occasion for the request was represented to be sufficiently urgent.

But suppose this were not the case and that Presidential requests for tax changes to prevent or to moderate major economic disturbances encountered in the Congress serious resistance, whether based on disagreement about the accuracy of the forecast upon which a timely request by the President must be based or disagreement about the kind of compensatory action to be taken. The cost of the delay involved, in terms of increases in unemployment, on the one hand, or increases in the price level, on the other, are surely not to be treated lightly. Neither, however, should one casually dismiss the implications of setting up a tax-change mechanism which avoids the test of congressional approval. These implications need not be spelled out in this discussion, but surely the caliber of congressional decisionmaking is disparaged in proposals for accelerating enactment of stabilizing tax changes by sidestepping normal legislative procedures.

To recapitulate, recent experience supports the contention that it is the delay in recognizing the need for compensating tax action, not the delay in enacting such measures, which is basically responsible for the tardy response of fiscal policy to destabilizing developments. Most of the proposals for increasing the speed with which discretionary tax changes would be afforded, however, are based on the assumption that it is the latter lag which must be reduced. These proposals would contribute little to improving stabilization policy. Indeed, they have a side effect of diverting attention from a basic requirement for more effective public action to offset short-term economic disturbances, viz, greater reliance on and improvement of short-term forecasting.

Apart from the issues, discussed above, concerning the desirability of some sort of standby tax-change mechanism, there are important questions regarding the nature of any temporary change in taxes for purposes of offsetting or moderating cyclical disturbances. One of these questions is whether any such tax change should be neutral; another is which type of tax change is most efficient.

The concept of a neutral short-run change in taxes is by no means clear a priori. "Neutral" could be construed to mean that the change in liability for the specific tax (or taxes) involved is in the same proportion for everyone paying the tax (or taxes). The term may be more broadly interpreted to mean that the tax change does not alter the distribution of income among individuals by income level, or the distribution of income as between returns to capital and other shares of the national income, or the allocation of tax burdens as between individual and corporate taxpayers, or the composition of total output as between private consumption and private capital formation.

One may very well question whether a temporary tax change which was neutral in any of these broader senses could be effectuated.

One may also question whether neutrality is necessarily desirable for short-run, anticyclical tax action.

The principal argument in favor of neutrality—generally in the sense of equal percentage changes in income tax liabilities—is that this approach would minimize controversy in the Congress and expedite enactment of the desired change. In the context of proposals for some type of standby tax change measures, the contention is that Congress would insist on neutrality in this sense as a precondition for delegation of authority to the President. A collateral argument is that taking action against recession or inflation should not be the occasion for changes in the distribution of tax burdens.

It may well be that only neutral tax changes (in the sense of equal proportional changes in liabilities) would be acceptable readily enough to be useful, i.e., timely. The argument that stabilizing tax changes should not alter burden distribution, however, is not persuasive on other grounds.

The express purpose of short-term, temporary tax changes is to alter income claims in order to change the magnitude of total demand (or the rate of change thereon) and the composition of the use of resources. If the tax change is effective, there will at a minimum be a change in private demand and resource use to satisfy those demands relative to public demand. Beyond this, however, a number of criteria can be adduced for purposes of determining on any such occasion whether and if so how, resource use in the private sector should be altered. No once-and-for-all rule is likely to be suitable nor is the justification for such a constraint on reordering the priorities of policy objectives readily apparent.[5]

Again the current situation may be cited to illustrate the point. Suppose that a forecast of the next year to year and a half indicated a continuing strong expansion of defense demands and business orders for capital goods which, taken in conjunction with projections of other components of aggregate demand, indicated strong inflationary pressures. One line of argument might well be that stabilization policy calls for moderating business capital goods demands in order to achieve a more sustainable rate of expansion of the stock of capital goods, and this would suggest a tax increase in the business sector, particularly

[5] Except for the reason cited previously, i.e., to expedite agreement and action.

one which serve to increase the price of capital goods; e.g., a temporary withdrawal of part or all of the investment credit. On the other hand, an opposing argument might minimize the danger of a subsequent sharp downturn in capital formation and urge that the high rate of investment in the forecast be validated by constraining the expansion of consumption demand, thereby freeing resources for the production of capital goods. In either case, the so-called neutral tax change would be deemed to be inappropriate. Indeed, it is difficult to conceive the circumstances in which one would not want some shift in resource use as a means of accomplishing the stabilization objective.

The question of which tax temporarily to alter for stabilization purposes is extremely difficult to answer on an empirical basis, since there has been virtually no experience with temporary tax changes to this end. In theory, temporary changes in individual income tax liabilities are likely to be less effective in altering consumption outlays than tax changes which operate more directly on the prices of consumption goods: the benefits or disadvantages of the income tax change—the change in disposable income—are realized irrespective of the taxpayer's response to these changes, whereas the benefits of, say, a temporary general sales tax reduction are realized only if the taxpayer increases his consumption of items on which the tax has been reduced during the period in which the lower rates are in effect; by the same token, to avoid the additional burden of an increase in such taxes, he must reduce his consumption of the now more expensive, taxed items.

The same sort of reasoning applies in the case of business taxpayers. If the sole consideration in making temporary tax changes were to get the largest change in spending per dollar change in tax liability, then the most effective tax to change would probably be a gross value-added tax, applied without exceptions and allowing no deduction for capital outlays or depreciation; such a tax would be the equivalent of a flat-rate income tax on gross national product.[6]

Getting the biggest reaction per dollar of tax change may not necessarily be, however, the most important criterion of stabilizing tax changes. The proposition that the best tax change is the smallest one needed to provide the desired change in total spending has long been disputed.[7] As suggested above, the occasion for stabilization action may well also be the occasion for changes in priorities among policy objectives, and effective pursuit of the reordered goals may not be consistent with "most bang for the buck" rules.

NEW YORK, *March 26, 1966.*

Hon. MARTHA W. GRIFFITHS,
Member of Congress, House of Representatives,
Washington, D.C.

DEAR MADAM CHAIRLADY: In view of the hearings presently being conducted by your subcommittee, I believe the enclosed proposal will be of interest to you. I suggest a simple method by which disposable current income may be reduced or increased, quickly and flexibly, to offset inflation or depression when either seems dangerously imminent, without any change in the amount of income taxes owed to or the amount of revenues retained by the Federal Government.

The present proposal is a development of proposals made and published in 1942 and 1958 with respect to control of disposable income in periods of inflation or recession.

If the plan has merit in your eyes, this is a propitious time to put it in effect. It will be much easier to do so during a period of anticipated inflation since, obviously, taxpayers prefer a future tax credit for overpayment to an increase in present taxes which the Government keeps. As New York State Senate Minority Leader Joseph Zaretski said yesterday with respect to Mayor Lindsay's program to increase taxes, "I don't think it will hurt any lawmaker to vote against taxes."

With all good wishes, I am,

Respectfully yours,

JEROME WEINSTEIN.

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[6] See the statement of Arnold C. Harberger in these hearings.

[7] For example, see William J. Fellner, "Relative Emphasis in Tax Policy on Encouragement of Consumption on Investment," Subcommittee on Tax Policy, Joint Economic Committee, "Federal Tax Policy for Economic Growth and Stability, Compendium of Papers," 84th Cong., 1st sess. (Joint Committee print 1956), pp. 210–217.

A Proposal for Stable Income Tax Rates During Both Inflation and Recession

"A tax system must, of course, provide the revenues needed to cover Government expenditures over reasonable periods, though a balance is not required every year—but it is important that the full benefits of tax revision should not be jeopardized by the hasty improvisation of reductions in the hope of countering cyclical downturns in economic activity."—Presidents' Economic Report to Congress, President Eisenhower, January 18, 1961.

"The 1948 tax reduction was intended as a permanent one. The 1954 tax cuts were also intended as a permanent adjustment to sharp reductions in Government expenditures at the end of the Korean emergency. But a recession will not always coincide with the need for permanent tax reduction. The temporary fluctuation in private demands that are commonly responsible for cyclical movements in business activity may thus call for temporary adjustments in fiscal policy that can be reversed as the need for them recedes."—Annual report of Council of Economic Advisers, Walter W. Heller, chairman, and Gardner Ackley, January 14, 1963.

We still operate a roller coaster system for income tax rates. They were reduced in 1964 and 1965, to stimulate the economy. Now it is asked they be increased to halt inflation.

According to present fiscal tax theory, income taxes should, and in fact sometimes do change with fluctuations in the economy, rising after inflation begins and falling after recession starts.

Such changes are made to counterbalance changes in demand adversely affecting economic activity.

That is an untidy way to regulate economic activity. It does indirectly that which can be done directly and more flexibly. Apart from its other defects, it requires that the Government collect and keep for itself more income tax revenues than it needs and requires the taxpayer to owe more taxes than the Government desires to use. In his press conference this week, President Johnson, discussing an increase of tax rates to restrain inflation, quoted the statement in the report of the Council of Economic Advisers received by him March 20:

"Throughout the next 15 months, the increases in Federal revenues which are drawn out of the economy will exceed the increases in Federal expenditure that add to private purchasing power."

It thus becomes plain that if tax rates are now raised to check inflation, it will be done only to stop people from spending so much by taking a part from their current income away from them, and for keeps.

Increasing tax rates temporarily to check inflation and reducing them temporarily to offset recession is neither necessary nor desirable. By increasing or reducing the rate of payments for income tax owed on current income, temporary reductions or increases in the amount of disposable current income can be achieved without any change in present income taxes. Any temporary overpayment or underpayment of taxes owed on current income will, so long as it continues, reduce or increase disposable current income in the same amount as an increase or reduction in income taxes over the same period.

The method proposed is a simple one. By it disposable current income can be increased or reduced and quickly and flexibly changed for periods of 2 or 3 or 4 months at a time as indicated by dangerous trends in the economy and sound fiscal tax policy.

The method is one that was used by the State of New York from 1946 until 1958 to conform State income tax receipts to changes in the revenue needs of that State; and this was without making any change in the standing statutory tax rate. The statutory income tax rates of New York State in effect at the end of the war would have produced far more income tax revenues than the State needed. Instead of revising income tax rates each year in conformity with the changing State need for revenue, the legislature would each year abate part of the income tax by voting a tax credit or discount rate to be applied in reduction of the tax computed at the standing statutory rate. In various years the tax credit was 50 percent, 40 percent, 10 percent, and finally 15 percent of the first $100 of tax and 10 percent of the next $200 of tax. The tax credit ceased when rising financial needs of the State required all the revenues which could be raised by the statutory income tax rates.

The same procedure used by the State of New York to adjust tax collections to the revenues needed each year could be used to adjust Federal income tax collections in amounts sufficient to offset short-term swings in the economy either up or down; and this without any changes in the effective tax rate or the amount of taxes owed by the taxpayer on the year's income.

This is how it can be done. A statutory standard tax rate, 25 percent higher than presently scheduled income tax rates would be enacted as standing legislation. At the same time there would be enacted a standard tax credit for 20 percent of the tax due under the scheduled standard tax rates. The standard tax rate when reduced by the standard tax credit will establish an effective tax rate under which the amount of taxes owed is exactly the same amount owed under present income tax rates.

The full amount of the standard tax credit would, without further action, apply automatically in the absence of its adjustment by Congress. Whenever it appeared desirable to Congress to reduce disposable current income because inflation seemed to threaten or to increase demand because recession appeared imminent, the rate for application of the standard tax credit could be modified by Congress so as to produce the desired effect on disposable income. A 1-percent reduction in the standard tax credit would be equivalent to, and have the same effect on disposable current income as an increase of 1.25 percent in present tax rates. A reduction of the standard tax credit to 16 percent would, for the period affected, be equivalent to a 5-percent increase in present tax rates; a reduction of the standard tax credit to 12 percent would be equivalent to a 10-percent increase in current tax rates; and the credit reduced to 12 percent would be equivalent to a 15-percent increase in present tax rates. Attached is a schedule showing the result of various reductions in the standard tax credit.

The changes in the standard tax credit, when made by Congress, would be in effect only for the period, and at the rate, which Congress decided was sufficient to offset the dangerous trend of the economy. The tax credit could be adjusted as pronounced changes in the economy made it appropriate. After a change in the standard tax credit it is unlikely that any further adjustment would be required within 3 months, thereafter.

A reduction in the 20-percent standard tax credit would result in an overpayment for the amount of taxes owed (which amount remains constant at the standard tax rate less the standard 20-percent tax credit; i.e., the amount owed at present rates). If it should appear from the taxpayer's income tax return on a full year's income that there remains a tax credit for overpayment in excess of 10 percent of the taxpayer's income tax due for that year, the excess automatically would be refunded. Overpayments not exceeding 10 percent of the amount of tax due for the year shown would be held for a continuing tax credit upon taxes thereafter accruing.

This 10-percent overpayment of taxes on a year's income would provide a reservoir of tax credits to be released for reduction of taxpayments when a recession seemed to threaten. This is an ancient and effective device to compensate for shortages in the economy, as appears from the following quotation:

"34. Let Pharaoh do this, and let him appoint officers over the land and take up the fifth part of the land of Egypt in the 7 plenteous years.

"35. And let them gather all the food of those good years that come, and lay up corn under the hand of Pharaoh, and let them keep food in the cities.

"36. And that food shall be for store to the land against the 7 years of famine, which shall be in the land of Egypt; that the land perish not through the famine."

* * * * * * *

"56. And the famine was over all the face of the earth; and Joseph opened all the storehouses, and sold unto the Egyptians; and the famine waxed sore in the land of Egypt." [Genesis, ch. 40.]

Advantages of the proposed method over a frequently changed income tax rate schedule to offset short-term swings in the economy in part can be summarized as follows:

1. It is a procedure which is specifically applicable to control of fluctuations in the economy due to excessive or insufficient demand and, therefore, does nothing more or less than that. It does directly what manipulation of income tax rates does only incidentally and as a side effect of increasing or reducing taxes owed.

2. It is neutral in that it does not change taxes owed by the taxpayer and the amount of tax which belongs to the Government.

3. Because it is neutral in effect, and can be quickly applied and modified or reversed, it can be used when inflation or recession only is suspected. Its use need not be delayed until after it has been finally confirmed that inflation or recession is actually underway. The adjustments which would have been adequate initially, are likely to be too little or too late after the undesirable trend of the economy has gathered momentum. In the 1957–58 recession Congress and the administration continued to debate the need for a tax cut until some months after the recession had ended. In the meanwhile the earnings of industry declined 30 percent in the first quarter of 1958 as compared with a like period in the previous year.

4. Because it involves no change in the amount of tax owed to the Government, the applicable period and rate of the applicable tax credit can be quickly changed without the extended debate and argument which usually attend legislation which reduces Government tax revenues or increases the amount of taxes owed.

5. Because it changes neither taxes owed nor revenues retained, changes in the tax credit may be on a greater scale than would be feasible by change of tax rates.

6. Since the tax credit automatically reverts to the 20-percent standard tax credit on expiration of the period fixed for application of the modified tax credit, there is eliminated the probability that a tax reduction for recession will continue in effect after inflation has started or a tax increase to halt inflation will operate after recession has begun.

7. Since it does not change the amount of taxes to be owed but only the rate for collection of such taxes, it requires no further legislation once the standard tax rate and standard tax credit are enacted. Changes in the rate of tax credit applicable for a specified period, will be made by joint resolution of Congress approved by the President. Congress will act either on its own initiative or on the message of the President.

It may prove feasible for Congress to authorize the President, on his own initiative, to reduce the tax credit down to 16 percent (equivalent to 5-percent increase in present tax rates) for a period of 2 or 3 months, subject to further order of Congress. Such a power in the President would not infringe on the constitutional power of Congress over taxes since its exercise would neither increase nor reduce taxes, and would affect only the rate of collection. The present power of the Internal Revenue Department to grant or refuse extensions of time for payment of taxes owed has never been considered to be an infringement on the power of the purse reserved for Congress.

8. If errors or misjudgment are made in the alteration of rate or reduction of the standard tax credit, no harm is done to taxpayer or Government. This cannot be said of the consequences of increasing or reducing income tax rates.

CONCLUSION

The need for a simple and effective mechanism by which the amount of disposable current income can be flexibly and quickly modified to offset a trend toward inflation or recession is evident from past experience in changing income tax rates for these purposes. Because the proposed method avoids the need for frequent changes in tax rates to offset short-term swings in the economy, because it does directly what a change in tax rates achieves only indirectly, and because it is neutral in its effect on the amount of taxes owed and the amount of tax revenues retained by the Government, and because it permits rapid and flexible adjustments to changes in the economy, it is to be preferred to the present system of changing tax rates to offset inflation or recession.

Application of standard tax rate and standard or adjusted tax credits

Tax owed under present rates, monthly basis	Tax owed on same income computed under standard tax rates (25 percent increase over present rates)	Standard tax credit normally deductible from tax computed at standard rate (percent)	Amount of tax due under standard rate and standard tax credit	Modified rate of standard tax credit (percent)	Monthly payment at adjusted tax credit rate
$100	$125	20	$100	20	$100.00
100	125	20	100	18	102.50
100	125	20	100	16	105.00
100	125	20	100	12	110.00
100	125	20	100	10	112.50
100	125	20	100	8	115.00
100	125	20	100	4	120.00
100	125	20	100	0	125.00

NOTE.—The above table based on $100 a month, affords the basis for readily calculating the effect of the standard tax rate, the standard tax credit and adjusted tax credit on all levels of taxable income, under present income tax rates.

McLEAN, VA., *March 22, 1966.*

Representative MARTHA GRIFFITHS,
Chairman,
Subcommittee on Fiscal Affairs of the
Joint Economic Committee.

DEAR MRS. GRIFFITHS: The attention of the subcommittee is respectfully called to an apparent major conflict in philosophy between two segments of our Government. A conflict which directly affects every citizen.

The Office of Economic Opportunity estimates that the subsistence level of income for a family of four is $3,100 a year. "Subsistence level" would indicate that every dollar of this income is used for necessities.

The tax exemption rate for a family of four is $2,400 for dependents plus 10 percent of income for deductions. A family of four with one breadwinner and an income of $3,100 a year would therefore be taxed on the amount over $2,710. A husband and wife filing a joint return on this basis would pay $18 of Federal income tax and in most States would pay an additional tax to the State. Eighteen dollars sounds like a small sum but it would feed this family for 3 days. It appears to be something of a paradox to be spending substantial sums of money to enable people to attain subsistence level and then to turn around and take it away from them by taxation.

In view of these conditions perhaps the subcommittee would be willing to consider the possibility of increasing the exemption for dependents. The revenue loss could be compensated for by a pro rata increase in the rate of taxation itself. It should be emphasized that the present exemption was established in 1953. Between 1953 and 1966 there was an increase of 19.6 percent in the cost of living index. If the $600 exemption was a fair one in 1953 then a fair exemption today would be $720 per person. It is interesting to note that this figure would give our hypothetical family of four a total tax exemption of $3,190.

It is respectfully suggested to the committee that the two threats of inflation and over rapid credit expansion which now confront us are related. The problem is to overcome the threats without causing an adverse reaction in the economy as a whole. Obviously this calls for a technique of gentle restraint which can be easily controlled. The situation is not unlike that encountered when driving on icy roads where hard braking may cause a skid but a controlled pumping action will result in a safe stop.

Once a tax increase becomes law it is very difficult to change it so that a large part of the necessary control is lost. Possibly a combination of the measures suggested earlier in this letter and a very modified restraint upon credit, such as a required minimum percentage down payment would provide an adequate answer. One factor built into credit controls is that their very lack of popularity makes them easy to remove once the situation has been corrected.

Yours very truly,

PETER T. WOOD.

ZIMMERMAN, EVANS & LEOPOLD,
Atlanta, Ga., March 17, 1966.

Hon. MARTHA W. GRIFFITHS,
House of Representatives,
Washington, D.C.

DEAR REPRESENTATIVE GRIFFITHS: After reading reports of the current inquiry being conducted by your subcommittee into the tax versus inflation problem, the thought occurred that an independent analysis of this subject might be of interest to you.

The enclosed statement, "What is the Source of Deficit Money?" was recently forwarded for review by the President's Council of Economic Advisers; copy of their response is attached.

Would it be possible for this to be accepted by your subcommittee as a statement from a public witness? If desired, I would be happy to appear at the committee's convenience in person to present it and/or answer questions.

Sincerely yours,

JOSEPH H. LEOPOLD.

THE CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS.
Washington, March 19, 1966.

Mr. JOSEPH H. LEOPOLD.
Zimmerman, Evans & Leopold,
Atlanta, Ga.

DEAR MR. LEOPOLD: The President has asked me to thank you for your February 17 letter in which you enclosed your article entitled "What is the Source of Deficit Money?" This material was read with interest by several of the economists on the President's staff. It will be interesting to see what reception its publication receives. As with most new recommendations for economic policy, it is preferable to see what the reactions are among the professionals before they are given serious consideration by the Government.

Sincerely yours,

CHARLES B. WARDEN, Jr.,
Special Assistant to the Chairman.

STATEMENT BY JOSEPH H. LEOPOLD, ATLANTA, GA.

WHAT IS THE SOURCE OF "DEFICIT" MONEY?

A statement often repeated by economists and public officials in support of a Federal balanced budget, is the following:

"When the Government decides to spend more money than it receives from the citizens, that extra money is 'created out of thin air', through the banks, and, when spent, takes on value only by reducing the value of all money in the economy."

The above statement is false, as the following analysis demonstrates: Through the mechanism of loans and discounts commercial banks are continually creating new money "out of thin air" to finance current production and distribution of wealth. (Last year alone they created about $30 billion.) This new money is always accepted in the economy on a par with all other money; it is inflationary only if it competes with other money actively seeking a fixed amount of wealth previously produced. (In such case, the price rise would be due to the relative scarcity of goods, reflecting extra profit to the seller.)

NEW MONEY IS FUEL FOR GENERATING MORE WEALTH

But if, instead of competing with other active money for a fixed amount of wealth previously produced, the new money generates production of a corresponding amount of additional wealth, then it is not inflationary, but becomes monetary fuel performing a necessary function—indeed, a function that is mandatory if the additional wealth is to be created at all; since without expenditure of the new money, the new wealth obviously would not be produced. Since 1929 the commerical banking industry has "created out of thin air," and loaned to businesses and the Government, over $250 billion of new money to fuel production of the Nation's output. New money, therefore, is the medium that makes possible production of more wealth in an economy at ever-increasing rates. Curtailment in the rate of supply of new money must result in a corresponding curtailment of economic growth. This is why all recessions and depressions of the past have followed shortly after curtailment of the money supply.

EFFECT OF GOVERNMENT-SPENT MONEY SAME AS CIVILIAN-SPENT MONEY

In effect, economists have adopted the belief that new money created by banks for commercial loans is not inflationary; but if the same money is created for Government loans, it is inflationary. A corollary which follows from this proposition is that Government-spent money does not generate production of new wealth—only civilian-spent money accomplishes this. But this makes no sense since everyone knows that a Government-spent dollar commands the same wealth anywhere in the economy that a civilian-spent dollar does. As every Member of Congress has learned, owners certainly do not frown on, or shy from, producing wealth in exchange for Government-spent dollars. Therefore, within the productive capacity of the economy, including its capability of expanding capacity newly created Government-spent dollars are not inflationary for the same reason that newly created civilian-spent dollars are not inflationary.

THE GOVERNMENT CAN CREATE ITS OWN "DEFICIT" MONEY

From the foregoing, it also follows that the Government can create its own "deficit" money, and need not have it created by commercial banks as it now does. As a matter of fact, all new bank-created money is honored in the economy only because Congress, in effect, has instructed the Federal Reserve System to convert the bank-created money into legal tender on demand of citizens. Since Congress also requires the Federal Reserve System to convert all authorized Treasury checks into legal tender on demand of citizens, Treasury checks, all by themselves, are perfectly sound money. The belief, implemented by present official monetary policy, that it is necessary for commercial banks to first create "deficit" money "out of thin air" and then lend it to the Government before it can be spent by the Government, is false for the same reason that a father should not be prevented by his child from performing certain work just because father taught child how to perform similar work.

President Lincoln, when confronted with the choice of issuing Government bonds to banks to obtain "deficit" money, or issuing new money directly to the economy, decided as follows: If the Government can issue a dollar bond, it can issue a dollar note. The element that makes the bond good, makes the dollar equally good. It is absurd to say that the Government can issue a bond but not a dollar.

Another way of stating this principle is as follows: If commercial banks can create money "out of thin air" and lend it to the Government at interest, the Government can create the same money "out of thin air" and save the taxpayers the interest.

From this analysis, it is apparent that at least the portion of the "deficit" created by commercial banks and loaned to the Government is unnecessary; the interest paid on these funds, amount to billions of dollars annually, reflects a parasitical drain on the productive sector of the economy. An understanding of the nature of the rest of the public debt follows from an inquiry into what money is; what determines its value; and what the money supply process consists of.

BASIC DESCRIPTIONS RELATING TO MONETARY THEORY

Money is media (articles or bookkeeping entries) that are generally accepted in an economy as proof of ownership of monetary units.

Functionally, monetary units are claims by their owners against human effort or the produce of human effort. They are also used to express the exchangeable value of other items not produced by human effort. The values of the latter items are subconsciously related by parties to the transactions to the current price level for human-produced articles, the standard of value for all wealth.

Quantitatively, the monetary unit is the official empirical unit used for measuring the exchangeable value of productive human effort; or what amounts to the same thing, the official unit used for measuring the exchangeable value of produce of human effort. In the United States, the monetary unit is the dollar, established by Congress in 1792.

Dimensionally, the dollar measures the various durations (expressed in minutes, for example) of different qualities of human effort that a dollar will command from citizens in the United States. In the case of workers, these durations are usually expressed in reciprocal form as wage rates which are monetary units per unit of time. In the case of the services of owners, the duration can be calculated from the percent profit received on a given volume of sales for a given duration of business activity. For the services of lenders, the duration can be calculated from the per annum interest rate paid for the use of borrowed money.

A monetary medium is considered "legal tender" when the people, through their government, declare it to be acceptable for the payment of all debts, public and private. The principal monetary media in the United States are bank deposits, currency notes, and coin. Only currency notes and coin are legal tender, although transfer of deposits (bookkeeping entries) via bank drafts are used for most financial transactions. For practical purposes, Treasury checks are legal tender because the people, through Congress, require that Treasury checks be converted into cash on demand of the payee.

The amount of currency notes and coin issued by the Treasury Department to the banking industry increases or decreases only as the public increases or decreases its requests to bank to have dollar deposits converted into cash. Under these procedures it is obviously impossible for the Government to circulate an excessive amount of cash. Deposits of all kinds, including deposits in savings and loan associations and other nonbank facilities, reflect about 95 percent of all the dollars in existence in the U.S. economy. The remaining 5 percent exists in the form of currency notes and coin, since this is all the cash that the citizens presently desire.

DIFFERENCE BETWEEN MONETARY MEDIA AND MONETARY UNITS

The key to understanding the "anatomy" of money is, first to differentiate between monetary media and monetary units," and then to identify who creates new monetary units using what monetary media. In the United States new monetary units are created only by the Government and the banking industry using the media listed in the following schedule:

Creator of new monetary units:	*Medium used to identify new monetary units*
U.S. Government	Treasury drafts (the real "tax" money).
Do	Currency notes (legal tender).
Do	Coin (legal tender).
Do	Federal Reserve drafts issued to retire portions of the "public debt."
Commercial banking industry	New deposit entries on the books of banks arising out of loans and discounts.

All monetary media are freely convertible either way from one to another, except Treasury and Federal Reserve drafts which are convertible to all other media, but which can be issued only by authority of Congress through the various appropriation acts, and the Federal Reserve Act. The money created by Federal Reserve drafts, issued to retire portions of the public debt," winds up on deposit with Federal Reserve banks as new member bank reserves," permitting the creation of new deposit money by the commercial banking industry. The Federal Reserve System has thus far retired $40 billion of the public debt in this manner.

METHODS FOR PERMANENTLY DESTROYING MONEY

Once monetary units are created, they remain in the economy forever to generate the production of more wealth, unless they are destroyed by one or the other of the following three actions:

(1) Physical destruction not replaceable.
(2) Bankruptcy or default of a debtor.
(3) Remittances to the Internal Revenue Service.

METHODS FOR TEMPORARILY "STERILIZING" MONEY

In addition to outright destruction through the foregoing, money can be "sterilized" or removed from active influence on the economy in one or the other of the following three ways:

(1) Cash hoarding.
(2) Deposits transferred from citizens' accounts to the books of the Treasury Department, for which "deposit receipts," called Government bonds, are issued.
(3) Held as bank reserves for possible emergency, such as a "run" on a bank.

JUSTIFICATION FOR REMITTANCES TO INTERNAL REVENUE SERVICE

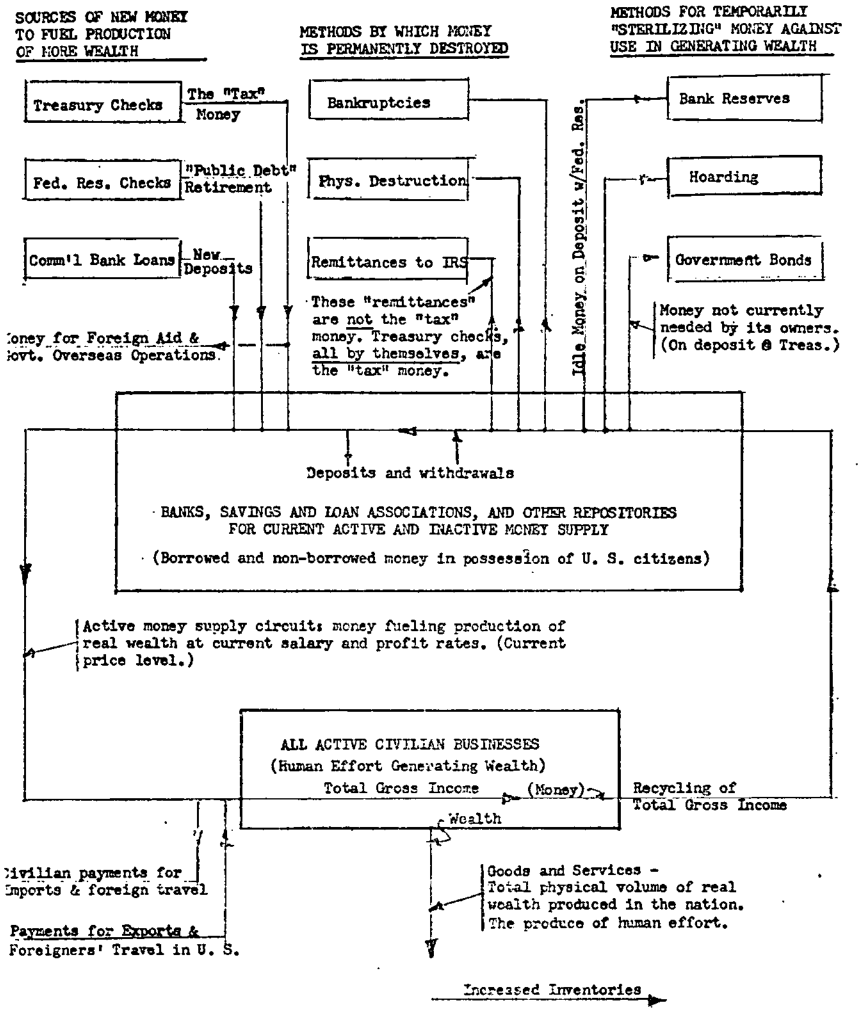
Item 3 (remittances to IRS) under the methods listed above by which money is destroyed, and item 2 (Government bonds) under the methods for temporarily "sterilizing" money, are justified only to the extent the economy does not have the industrial capacity to produce the wealth that would be purchased by citizens if they were permitted to retain the money in question for expenditure as they see fit. This is the only principle that should govern determination of the amount of earned purchasing power to be destroyed through remittances to the Internal Revenue Service, or that should be "sterilized" through issuance of Government bonds to the public. The balanced-budget concept is never a relevant consideration.

STATISTICS SUPPORTING UNWISDOM OF A BALANCED BUDGET

By way of confirming the foregoing, it is of interest to note that the U.S. economy has experienced its greatest growth during periods when the budget was furthest out of balance. For example, during the 6 years 1940 through 1945 the Federal budget was only about 40 percent balanced ($134.4 billion remitted versus $329 billion spent); and the average rate of output of real wealth increased over 9 percent per year. During the 6-year postwar period 1947 through 1952, the Federal budget was more than balanced ($264 billion remitted versus $260.2 billion spent); and the average rate of output of real wealth increased only about 4.5 percent per year. In other words, the economy grew twice as fast with a 60-percent deficit than it did with a balanced budget.

Statistics on inflation during the same two periods provide further enlightenment: During the period 1940–45 the wholesale price index rose 37 percent (from 42.2 to 59.9; 1957–59=100); whereas during the period 1947–52 the same index rose 41 percent (from 66.1 to 94.0). In other words, there was more inflation with a completely balanced budget than there was with a budget that was only 40 percent balanced. Among other things, these statistics confirm that inflation is caused by something other than a deficit, and from the foregoing explanation of what the dollar actually measures, it is apparent that inflation in the United States is caused only by U.S. citizens performing a shorter duration of productive human effort in exchange for each dollar of wages received. As regards the effect of deficits on the rate of economic growth, the statistics cited speak for themselves in pointing to the economic secret mankind has been seeking in vain for generations.

MONEY SUPPLY PROCESS AND ACTIVE MONEY CIRCUIT - SIMPLIFIED DIAGRAM



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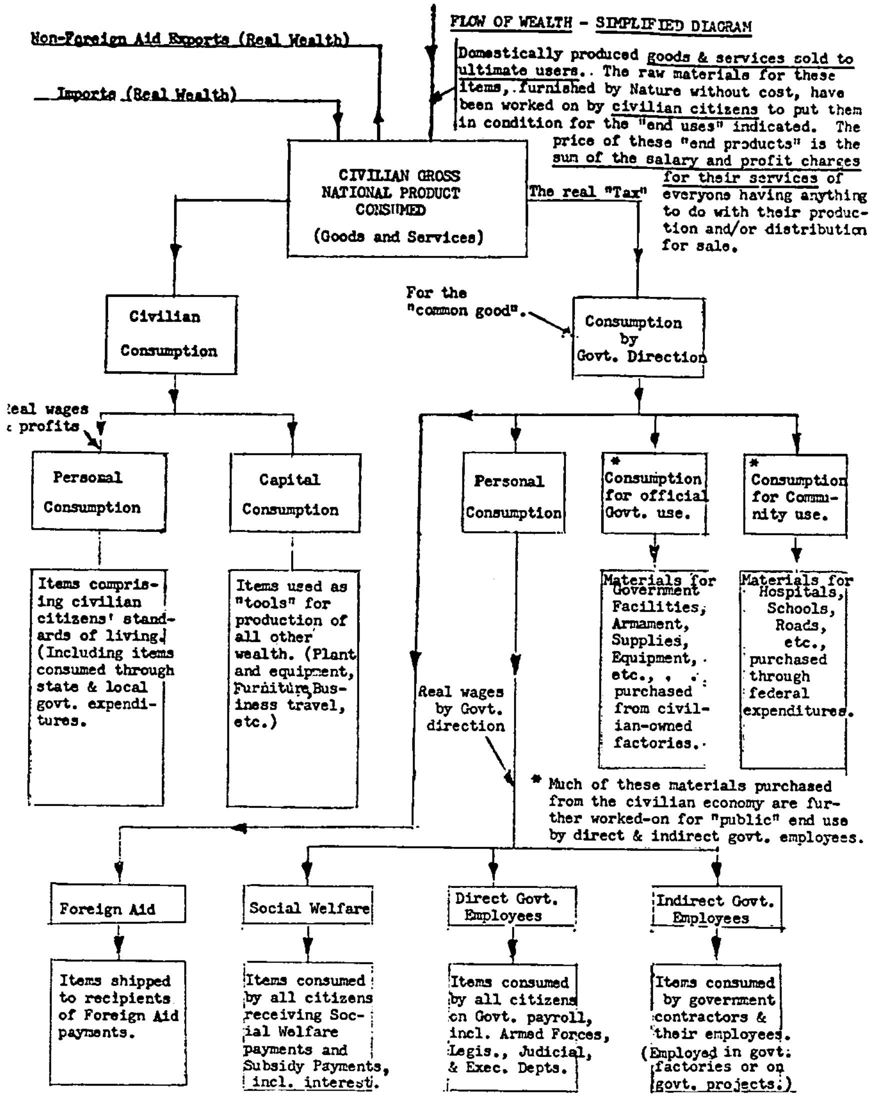
FLOW OF WEALTH - SIMPLIFIED DIAGRAM
Domestically produced goods & services sold to ultimate users.. The raw materials for these items, furnished by Nature without cost, have been worked on by civilian citizens to put them in condition for the "end uses" indicated. The price of these "end products" is the sum of the salary and profit charges for their services of everyone having anything to do with their production and/or distribution for sale.
Non-Foreign Aid Exports (Real Wealth)
Imports (Real Wealth)
CIVILIAN GROSS NATIONAL PRODUCT CONSUMED (Goods and Services)
The real "Tax"
Civilian Consumption
For the "common good".
Consumption by Govt. Direction
Real wages & profits
Personal Consumption
Capital Consumption
Personal Consumption
* Consumption for official Govt. use.
* Consumption for Community use.
Items comprising civilian citizens' standards of living. (Including items consumed through state & local govt. expenditures.)
Items used as "tools" for production of all other wealth. (Plant and equipment, Furniture, Business travel, etc.)
Materials for Government Facilities, Armament, Supplies, Equipment, etc., purchased from civilian-owned factories.
Materials for Hospitals, Schools, Roads, etc., purchased through federal expenditures.
Real wages by Govt. direction
* Much of these materials purchased from the civilian economy are further worked-on for "public" end use by direct & indirect govt. employees.
Foreign Aid
Social Welfare
Direct Govt. Employees
Indirect Govt. Employees
Items shipped to recipients of Foreign Aid payments.
Items consumed by all citizens receiving Social Welfare payments and Subsidy Payments, incl. interest.
Items consumed by all citizens on Govt. payroll, incl. Armed Forces, Legis., Judicial, & Exec. Depts.
Items consumed by government contractors & their employees. (Employed in govt. factories or on govt. projects.)