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JOINT COMMITTEE PRINT

FISCAL POLICY ISSUES OF THE COMING DECADE

STATEMENTS BY INDIVIDUAL ECONOMISTS AND REPRESENTATIVES OF INTERESTED ORGANIZATIONS

MATERIALS SUBMITTED TO THE

SUBCOMMITTEE ON FISCAL POLICY

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

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LETTERS OF TRANSMITTAL

FEBRUARY 15, 1965.

To the Members of the Joint Economic Committee:

Transmitted herewith for the use of the members of the Joint Economic Committee and other Members of Congress is a compendium of statements on the fiscal policy issues that are likely to concern the Congress in the coming decade. The statements were prepared for the Subcommittee on Fiscal Policy by individual economists and representatives of interested organizations. The 58 contributions to the compendium discuss such matters as the significance of present trends in Federal revenues and expenditures, measures to strengthen the Federal Government's contribution to economic growth and stability, and the significance for Federal fiscal policy of the increasing importance of State and local government expenditures.

The statements do not necessarily reflect the views of the committee or any of its members.

WRIGHT PATMAN,
Chairman, Joint Economic Committee.

FEBRUARY 12, 1965.

Hon. WRIGHT PATMAN,
Chairman, Joint Economic Committee,
U.S. Congress, Washington, D.C.

DEAR MR. CHAIRMAN: Transmitted herewith is a compendium of statements by individual economists and representatives of interested organizations submitted at the invitation of the Subcommittee on Fiscal Policy and commenting on the fiscal policy issues that are likely to concern the Congress in the coming decade. The respondents discuss such matters as the future economic consequences of present trends in Federal revenues and expenditures, the applicability of full employment budget analysis to policy determination, recent or needed analyses of the impact of past policy decisions, measures to strengthen the Federal Government's contribution to economic growth and stability, suggested revisions of the tax structure, and the significance to Federal fiscal policy of the increasing importance of State and local government expenditures.

The compendium is assembled in two sections. The first contains statements from 48 individual economists associated with colleges and universities, business firms, labor unions, and research organizations. These statements represent individual views and should not be interpreted as necessarily reflecting the views of the organizations with which these individuals are affiliated. The second section of the compendium consists of 10 statements submitted by representatives of interested organizations. The committee staff has made some minor editorial changes in interests of uniformity. The compendium was assembled under the direction of Alan P. Murray of the committee staff.

The subcommittee wishes to express its appreciation to the individuals who contributed to this compendium. We feel certain that the views expressed will prove of interest to all the members of the committee, to the other Members of Congress, and to the general public.

The statements do not necessarily reflect the views of the subcommittee or its individual members.

MARTHA W. GRIFFITHS,
Chairman, Subcommittee on Fiscal Policy.

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FISCAL POLICY ISSUES OF THE COMING DECADE

INTRODUCTION

In the fall of 1964 the Subcommittee on Fiscal Policy of the Joint Economic Committee invited comments from leading economists and interested organizations on what were the most important fiscal policy issues likely to come before the Congress in the coming decade. The response to this invitation exceeded the subcommittee's expectations both as to the number of replies submitted and the careful attention which obviously went into their preparation. It is therefore the opinion of the subcommittee that their publication in the form of a compendium will benefit the members of the committee, the Members of Congress, and the general public.

The arrangement of the statements in the compendium follows the order in which they were solicited. On August 13, 1964, a letter from Mrs. Griffiths, chairman of the Subcommittee on Fiscal Policy, was mailed to a number of individual economists inviting them to submit their views, as individuals, on the fiscal policy issues likely to concern the Congress in the near future. Mrs. Griffiths' letter is reprinted below. The 48 replies received in response to this invitation are included, in alphabetical order by author, in part A of the compendium. In October a similar invitation was extended to a selected list of organizations. This letter is also reprinted below. The 10 replies submitted in response to the second invitation are grouped in alphabetical order by organization in part B of the compendium.

Formal statements were not requested and, indeed, it was specifically indicated that concise statements unaccompanied by extensive documentation would be quite acceptable. Thus, the replies varied considerably as to length, method of presentation, and organization. Some were submitted in the form of a brief letter, others as more formal statements of greater length. To achieve uniformity in the presentation of these statements, some editing by the committee staff was necessary. By and large, this editing consisted of the deletion of those portions of the replies which had no bearing on the principal statement, such as the letterhead and signature. In some cases, however, it was necessary because of space considerations to omit a substantial portion of supplementary or previously prepared material submitted along with or in lieu of a letter or statement.

Mrs. Griffiths' letters of August 13 and October 16 are reproduced below:

AUGUST 13, 1964.

DEAR ————: The Fiscal Policy Subcommittee of the Joint Economic Committee is undertaking a survey to determine what important fiscal policy issues are likely to face the Congress and the Nation in the coming decade. As chairman of the subcommittee I invite you to participate.

The Joint Economic Committee is charged with the responsibility for conducting continuing studies of the major economic programs of the Federal Government to serve as a potential guide to the legislative committees. In this light the subcommittee's interest lies in a discussion of the emerging issues which may require the attention of Congress in the near future. Subject to this constraint, we would like to obtain your views on such questions as the future economic consequences of present trends in Federal revenues and expenditures, the applicability of full employment budget analysis to policy determination, recent or needed analyses of the impact of past policy decisions, measures needed to strengthen the Federal Government's contribution to economic growth and stability, desirable revisions of the tax structure, and the significance to Federal fiscal policy of the increasing importance of State and local government expenditures. This list is furnished only as a guide. Please do not hesitate to discuss issues in any area you regard as relevant.

We are interested primarily in your individual views. Your reply will be held in confidence if you wish. In any event, if it is selected for release by the subcommittee, you will have an opportunity to revise and edit it. Lengthy, documented responses are not required.

Your participation in this project will be greatly appreciated. Your reply will help the subcommittee to develop an agenda for later, more detailed investigations.

Sincerely yours,

MARTHA W. GRIFFITHS,
Chairman, Subcommittee on Fiscal Policy.

OCTOBER 16, 1964.

DEAR ————: The Fiscal Policy Subcommittee of the Joint Economic Committee is undertaking a survey to determine the important fiscal policy issues likely to face the Congress and the Nation in the coming decade. As chairman of the subcommittee I invite you to participate in the survey by submitting your organization's views concerning the fiscal policy issues it feels will be of significant importance in the years ahead.

The Joint Economic Committee is charged with the responsibility for conducting continuing studies of the major economic programs of the Federal Government to serve as a potential guide to the legislative committees. In this light the subcommittee's interest lies in a discussion of the emerging issues which may require the attention of Congress in the near future. Subject to this constraint, we would like to obtain your views on such questions as the future economic consequences of present trends in Federal revenues and expenditures, the applicability of full employment budget analysis to policy determination, recent or needed analyses of the impact of past policy decisions, measures needed to strengthen the Federal Government's contribution to economic growth and stability, desirable revisions of the tax structure, and the significance to Federal fiscal policy of the increasing importance of State and local government expenditures. This list is furnished only as a guide. Please do not hesitate to discuss issues in any area you regard as relevant.

Replies submitted in response to its invitation will guide the subcommittee in the formation of an agenda for hearings which will probably be held early in 1965 and which in no event will be held before mid-November 1964. No decision as to whether, when, or in what manner the substance of the replies will be publicly released can be made at this time. When these decisions are made you will be promptly advised and your letter will not be quoted without the prior approval of your organization. Lengthy, documented responses are not required.

Your participation will be greatly appreciated.

Sincerely yours,

MARTHA W. GRIFFITHS,
Chairman, Subcommittee on Fiscal Policy.

PART A

STATEMENTS SUBMITTED IN RESPONSE TO MRS. GRIFFITHS' LETTER OF AUGUST 1964

NOTE.—The individuals whose statements are contained in this section were asked only for their individual views. Their replies, therefore, should not be construed as necessarily reflecting the views of any organization with which they may be affiliated.

STATEMENT BY G. L. BACH, PROFESSOR OF ECONOMICS, CARNEGIE INSTITUTE OF TECHNOLOGY, PITTSBURGH, PA.

This is in response to Representative Griffiths' letter of August 13, inviting a statement on the issues of fiscal policy which I believe the Subcommittee on Fiscal Policy ought to consider. My observations are organized under three main headings, although there is some overlapping among them.

COUNTER CYCLICAL STABILIZATION POLICY

1. How to achieve greater built-in counter-cyclical flexibility in our Federal-State-local fiscal system seems to me a major continuing problem. While we now have more built-in flexibility than previously, given our difficulties in accurate forecasting and in obtaining quick discretionary fiscal adjustments, stronger built-in, guaranteed-right-directional fiscal adjustments against cyclical fluctuations still promise more reliable results than do most other approaches.

2. Beyond stronger built-in flexibility, I believe the committee should investigate further possibilities of delegation of limited powers to the President to adjust tax rates upward and downward under conditions prescribed by the Congress. President Kennedy proposed one such arrangement to the Congress, but the subcommittee could well investigate further the possibilities of this and other arrangements which would be consistent with both maintenance of appropriate control by Congress and more discretionary counter-cyclical flexibility than is now possible with congressional action required on taxes and expenditures. Such investigation might include further discretionary powers for the President on some classes of expenditures, but this seems to me less pressing and less promising than does the tax side.

In connection with the whole problem of counter-cyclical policy, our knowledge of the lags between changes in Government spending rates or tax collections and the final economic variables of production and employment is grossly inadequate. Further committee investigation of this area could be valuable. Study of the 1964 experience, involving the tax cut and changes in the rate of growth of the money stock, is an obvious possibility.

3. Use of the concept of the full-employment budget balance marks a significant forward step in our fiscal thinking. There is, however, little evidence that the concept is yet fully understood and accepted by most Congressmen and laymen. I believe the committee could usefully investigate the concept further, and in doing so should specifically consider how far full-employment budget balance itself represents an appropriate goal of fiscal policy. While the full-employment budget concept is very useful, full-employment budget balance per se is not necessarily an acceptable goal of fiscal policy under all conditions. On the contrary, countercyclical stabilization policy may require a full-employment budget surplus or deficit, depending on the state of the private economy.

THE LONGRUN IMPACT OF THE FISCAL SYSTEM

4. I consider our knowledge on the effects of different taxes and tax rates on incentives to work and invest as seriously inadequate, and I believe the Subcommittee on Fiscal Policy could usefully stimulate a further examination of these issues. The probability of obtaining useful results without some further real research is, however, not high. The problem is not merely one of eliciting the general views of more observers.

5. Further examination of possible new approaches to the Federal-State-local mix of fiscal responsibilities on both tax and expenditure sides is needed. The public appears currently to prefer reliance on State-local expenditures for rapidly growing needs such as education. Yet the evidence seems clear that Federal collection of mass taxes (like the income tax) is more efficient than State or local systems, and certainly we must look to Federal fiscal action for countercyclical stabilization policies. Thus, it might be valuable to consider apparently radical schemes involving major returns to State (or local) governments of budget surpluses obtained by the Federal tax system as the full-employment budget rapidly moves toward a surplus position with economic growth. Other such Federal-State-local arrangements might be fruitfully explored.

6. The longrun impact of creeping inflation on the real position of Federal-State-local governments needs further investigation. While wholesale prices have been remarkably stable for several years, the consumer price index, the GNP deflator, and any reasonable index of prices paid by government units have all crept up steadily. Few observers believe we will have less rapidly rising prices in the future; many believe more, on the average. What are the implications of such a creeping inflation for the net control over resources in the system by governmental units (reflecting both tax and expenditures sides); and what issues of equity as among various groups are raised? On this issue it is probably important to differentiate between the position of Federal, State, and local governments.

7. When the Federal budget generates an undesirably large full-employment surplus, is it more desirable to lower tax rates or to raise expenditures? This seems to me a central issue of fiscal policy. However, alas, I'm not sure that hearings by the subcommittee at this time would add very much to the already huge discussion on this subject.

8. What is the optimal trade-off between price stability and avoidance of unemployment for fiscal and monetary policy actions? While this issue has been discussed before various committees, the Subcommittee on Fiscal Policy might render a service by investigating more thoroughly and objectively the relative costs of given (moderate) amounts of inflation and given (moderate) amounts of unemployment. Some academic economists have made preliminary studies along these lines. Such a comparison must logically be the foundation for policy decisions that involve trade-offs, and we would be much better equipped to make wise decisions if we had better quantitative, objective evidence on the relative costs. Ideally, such trade-off measures would include the balance of payments as well, though this seems to me to be more difficult to measure effectively.

ISSUES OF EQUITY AND TAX REFORM

9. Perhaps all the issues of equity in tax reform were discussed as far as they usefully could be during the extensive hearings on the tax bill last year. Nevertheless, I believe the Subcommittee on Fiscal Policy could usefully reconsider the total net impact of Federal and Federal-State-local tax and expenditure patterns on various income and occupational groups. We have no adequate, up-to-date data on the total redistributional impact of either the Federal fiscal system alone or Federal-State-local fiscal systems combined. Studies first presented before this committee some years ago by Musgrave and others played an extremely useful role in providing facts as a foundation for discussion of equity issues. With current interest in the poverty program and other distributional issues, more basic research and a committee investigation along these lines would seem useful, both in developing the facts and in analyzing their implications for alternative policies.

Particular issues of tax equity such as capital gains treatment, depletion allowances, exemption of State-municipal securities, and the impact of such regressive excises as liquor and tobacco taxes should continue to command a central place in any reconsideration of the equity of governmental fiscal systems. I am not sure that further investigation by the Subcommittee on Fiscal Policy of such technical tax issues would play a particularly useful role at this time, however.

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STATEMENT BY WILLIAM J. BAUMOL, PROFESSOR OF ECONOMICS, PRINCETON UNIVERSITY, PRINCETON, N.J.

1. The tax reduction seems to have had very beneficial effects on the economy. Its apparent success as an economic stimulus reemphasizes the dangers in overrestrictive fiscal policies. I think a reasonably conservative fiscal standard calls for a Federal budget which balances only when something approaching an acceptable level of employment is reached. It should yield a surplus when the demand for labor exceeds this amount and produce a deficit whenever the level of unemployment rises above the acceptable level. I think there is persuasive evidence that before the tax cut the Federal budget was far too restrictive in terms of this criterion—that, other things being equal, it would have yielded a substantial surplus in a full employment economy.

2. Nevertheless, I believe that there are dangers in placing too heavy reliance on deficits alone as a means for reducing unemployment and eliminating sluggishness in the economy. With prices and wages determined in the way they are currently, significant inflationary pressures may be produced by such measures well before an acceptable level of employment is attained. I believe we have not really faced up to the problems of inflation inherent in standard full employment policy proposals. An effective fiscal program must provide adequate fiscal stimuli for effective demand, but it must also contain measures which prevent such increases in demand from being translated directly into price and wage rises.

3. A thorough program of tax reform should be reintroduced for consideration by the Congress. The original tax reform program was mutilated and largely lost during the course of the efforts to secure passage of the tax reduction last year. It would be highly regrettable if no further effort were devoted to tax reform.

4. Increases in State and local expenditures are an unavoidable consequence of the types of responsibility which devolve on these governments. Indeed, I believe that local expenditures on many items such as education, police protection, and public transportation have not nearly kept up with the needs by any reasonable standard. Federal programs such as the mass transportation bill, the various measures providing aid to education, etc., all go in the right direction. However, in the long run, more substantial contributions will be essential because the needs will continue to grow while there is relatively little flexibility in the sources of funds available to local governments. These needs and their likely order of magnitude should be investigated thoroughly and this should be done soon.

STATEMENT BY JONATHAN A. BROWN,[1] DIRECTOR, DEPARTMENT OF RESEARCH AND STATISTICS, NEW YORK STOCK EXCHANGE, NEW YORK, N.Y.

INTRODUCTION

Fiscal policy has been defined as, "* * * the coordinated policy of a government with respect to taxation, the public debt, public expenditures, and fiscal management, with an objective, for example, of attempting to stabilize national income of the economy." [2]

Thus, in selecting some important fiscal policy issues likely to face Congress and the Nation in the coming decade, it seems desirable to discuss these issues in four separate categories; namely, (1) taxation, (2) expenditures, (3) issues relating to debt management, and (4) issues which involve interrelationships between the first three—especially the level of revenues from taxation versus the level of Federal expenditures.

PERSONAL POINT OF VIEW

The fiscal issues which one would select as likely to be important in the years ahead are naturally influenced by personal beliefs and by inherent prejudices. Thus, a brief discussion of them would appear to be essential before posing any questions—as a basis for better understanding the reasons for particular emphasis.

There can be little argument, for instance, with the concept that the Nation should endeavor to achieve at least between 3 and 4 percent annual rate of economic growth, with relatively stable prices and generally uninterrupted progress. More controversial is the question of the degree to which this growth should be dependent primarily on the private enterprise economic system operating in a relatively free market economy, with maximum reliance on individual initiative and the incentives of private ownership, compared to stimulus through large-scale government expenditures.

My personal viewpoint calls for a minimum resort to all nonessential Government expenditures, whether they be justified as necessary subsidies, marginal public work projects, or schemes for the redistribution of income and wealth. Transfer payment actuarially paid for by the beneficiaries thereof are, of course, acceptable if they cover legitimate areas. Subsidies and schemes to equalize living standards should be labeled, measured, publicized, and legislated as such, so that they will stand revealed in their true nature, not hidden from public scrutiny.

The American people must also appreciate the fallacy of a "something for nothing" philosophy, which idea already shows too many signs of becoming a major tenet of our economic system. As a basic

[1] The views expressed are those of the author personally and not those of the organization for which he is the director of the department of research and statistics.
[2] "Encyclopedia of Banking and Finance," 6th edition, p. 277.

rule, the benefits of economic progress should be enjoyed by the producers thereof and as directly as possible in proportion to their contribution. Moreover, the citizenry should be the direct determinants of how most of their personal incomes are to be spent, not have an increasing portion of their incomes allocated through governmental channels.

Fiscal policy must be formulated with full cognizance of the importance of adequate rewards for risk takers and savers—those whose contributions to our country have played such a major role in our economic progress. Among other things, these adequate rewards mean encouragement to broader ownership of the means of production, and direct participation in the ownership of corporate America by as many individuals as is consistent with their risk-taking abilities and propensities.

Similarly, this personal set of values calls for a look at fiscal policy from the point of view of the individual citizen as an independent, self-determining economic unit, as well as a taxpaying and benefit-enjoying member of a society in which Government spending now accounts for roughly one-third of all economic activity.

My fears of Government spending are centered on the fact that it too often lacks "profit and loss" accountability. It can proliferate too readily, become an entrenched interest, crowd out more efficient organizations, and ultimately weaken our entire economic system by discouraging initiative and self-reliance.

Thus, when fiscal issues of the coming decade are considered in detail, it would appear timely to measure their impact on the entire structure and goals of our society, not just their economic implications considered alone.

SOME OF THE MAJOR FISCAL ISSUES OF THE COMING DECADE

Selected issues in the coming decade in the specific areas of Federal expenditures, revenues, and debt management are explored in detail in the next sections. In this section, it seems desirable to pose a few of the broad issues in general terms—particularly those which concern the interrelationships between revenues and expenditures. Here are five such issues:

1. One issue worth examination would certainly be the acknowleged success of our Nation's economic experience of the past 4 years, and what lessons this experience tells us about the appropriate role which fiscal policy should play. This would obviously include an appraisal of the tax reductions and revisions of 1962 and 1964, and what impact those had on the economic thrust which has been apparent since the cuts were enacted last spring, and in 1962.

2. Another major issue concerns an examination of the role of private business in the past 10 years of economic progress, in relation to the role of Government and its compensatory fiscal policy, as a stimulant to economic growth. A detailed examination of the outstanding past performance of private business, and what may be expected of it in the next 10 years, is suggested as an area meriting detailed examination.

3. Constant reexamination of the many criteria used in measuring our economic progress would appear to be a critical issue. This re-

examination should cover many areas. But one area requires special consideration because it comes so close to the basic human issues involved: that there should be a detailed examination conducted of the significance of the unemployment statistics as a guideline for economic policy. It is particularly necessary to explore how the unemployment statistics are currently constituted. There should be a growing awareness that underneath the aggregate statistics are many individual types of unemployment—only a few segments of which should carry significant weight in influencing fiscal policy. Certainly, it is important, in policy determination, to differentiate between chronic, cyclical, seasonal, temporary, and "convenience" unemployment.

4. In addition to the relatively narrow but important question of measuring unemployment, is the question of how we weight the unemployment statistics in relation to many items which reflect the national economy. By overweighting them in relation to a composite view of all national interests, are we paying too great a price for just one element of our economic equation?

5. Another complex issue that may manifest itself soon concerns the optimum allocation of any surplus Federal revenues over expenditures (if and when they may materialize from our present revenue system and our growing economy).

(*a*) What about the desirability of a reduction in the national debt?

(*b*) Should an increased proportion of Federal revenues be allocated back to the States for State or local purposes?

(*c*) What portion of expanding revenues needs to be reserved for essential Federal spending requirements of the coming decade? And,

(*d*) What portion should be set aside for more tax reduction?

It is recommended that various computer-simulation techniques be employed to measure the impact on the national economy of assumed alternative amounts of surplus funds, with various assumed proportions being allocated to the four alternatives listed above. Such simulation would include model building to measure the relative impact on the economy from privately spent dollars compared to Government programs. These models should be constructed by persons of known technical competence, professionally knowledgeable, and impartial regarding the weighting of the various components which might make up the alternative models.

MAJOR ISSUES IN THE AREA OF REVENUES

1. Economic growth of the country is largely dependent on capital investment by private enterprise. Therefore, the most important single issue in the area of fiscal policy for the next decade is almost certainly the increased recognition which our tax system should grant to stimulating private savings and encouraging capital formation through private enterprise.

Included in this vital area would be a tax policy geared to providing adequate incentives to capital investment through reduced capital gains rates and a shorter capital gains holding period. Such a tax development—by unlocking billions of locked-in gains—would not only help to stimulate the economy, but it would be a major shot-in-the-arm for tax revenues themselves.

Moreover, our tax laws must provide adequate relief for double taxation of dividends. This can be achieved through redress at either the individual stockholder level, or some other appropriate means at the corporate level. In either case, it would be an essential step to helping stimulate private investment, with significant indirect benefits to tax revenues through its stimulus to economic growth.

2. Another tax issue of the next decade should be the relative reliance the system placed on various degrees of progressive taxation compared to a less progressive structure. A start in eliminating an overly progressive tax structure was made in the 1964 Revenue Code. Further changes are warranted, especially on the upper and middle income levels, to help stimulate savings, and to reduce the pressure for various tax-alleviation and tax-sheltering devices. Changes are warranted also to avoid discouraging initiative, and to encourage maximum human effort.

One step in this direction which should be considered thoroughly is the development of a broad-based, flat tax on all gross income. This tax—as a partial substitute for our present income, corporate, and excise tax system—could eventually be a fourth major source of tax revenues. Through it, many of the proliferations and present inequities in our current tax system could be corrected, because such a revenue source would provide the necessary funds to offset the revenue losses necessary for elimination of presently unwarranted inconsistencies and anachronisms.

3. A third revenue issue is the desirability of greater reliance on some form of broad-based excise tax or even a value-added tax compared to a tax which is levied on corporate profits.

Such a change might well make a significant contribution to our international balance-of-payments problem, as well as contribute to sounder tax policy in the field of corporate taxation.

MAJOR ISSUES IN THE AREA OF GOVERNMENT EXPENDITURES

Federal Government expenditures have more than doubled in the past 15 years. Expenditures by State and local governments have risen even faster. In fact, the rate of expenditures at all levels of Government has increased somewhat faster than GNP, personal incomes and many other measures of economic growth.

Those elements in our national budget which concern defense spending depend substantially on the tranquility of our political relationships throughout the world. However, the rate of increase in our governmental spending, excluding defense, appears to be outrunning our fiscal resources—particularly at the State and local levels.

Certainly, the need of the times is for greater reliance on a pay-as-you-go or actuarially funded philosophy in Government, whether this applies to our roadbuilding programs, social security payments, educational expenditures, or some form of medicare. More and more people must become alert to the fact that the Government cannot provide all things for all people without appropriate sources of funds to pay for them—where feasible—from taxes paid 100 percent by those enjoying the services. And where it is Federal policy to deliberately redistribute these funds, should that not be spelled out in understandable and recognizable form?

Almost half the Nation's population are either under 20 or over 65 years of age. For society to carry these largely nonproductive age groups places a tremendous burden on those 21 to 64. In addition, most of those in the active working force are trying to sustain or advance their own present living standards. The burdens being imposed on us by ourselves, by our aspirations for our children and our old age, and by our national defense expenditures are already creating a difficult budget situation for too many homes in America.

Thus, there is continuing demand for strong control and supervision over the expenditures involved in all Government activities—at all Government levels. A major fiscal issue of the coming decade would certainly appear to be how to achieve better control by Congress over the expenditure authorizations, appropriations, and obligational authorities in which legislation itself determine the level of expenditures.

Moreover, related to congressional control is the issue of prompt timing and appropriate flexibility in relying on Government spending as a countercyclical measure. An area to study might well be the time it takes to initiate intelligent increases in Government spending, and the time required to spread the results effectively throughout the economy.

DEBT MANAGEMENT ISSUES

Will it ever again be appropriate, from the point of view of the Nation's economy, to undertake any sizable reduction of the national debt? Such a reduction could, of course, contribute to reducing the expenditure side of the budget due to the substantial costs of carrying the present national debt. But would the impact on economic growth be too serious a price to pay?

Another issue of the next decade worth consideration is the handicap of the present statutory interest ceiling on flexibility in debt management. This would appear to be a timely issue even though it implies a question about the higher interest rate levels sometime in the coming decade.

Today, there is a pronounced seasonal flow in Federal revenues and some seasonality to expenditures. As social security tax rates and income levels rise, this relatively greater flow of revenues to the Federal Government in the spring months seems likely to increase. To what extent does this place a fiscal drag on the economy in the early months of the year—often when weather factors also place an additional impediment on economic expansion? Is this not a major fiscal management issue warranting investigation by this subcommittee?

Finally, other fiscal management issues might include technicalities involved in the distribution of the maturity of the public debt; the use of the Nation's registered securities exchanges for trading long-term Government bonds; and the use of new merchandising and promotional methods to finance the public debt in various noninflationary ways.

CONCLUSION

There are a number of major fiscal issues facing us in the coming decade, and an incalculable array or related and supplemental questions.

Fortunately, the past decade has supplied a wealth of experience, mostly favorable, upon which to draw.

Among the most significant factors in this experience have been the increase in corporate profits, the level of private savings, and the rate of capital expenditures by private business as keys to the Nation's economic progress. For without these, the Nation could not have moved ahead so dynamically without any drastic increase in the relative proportion of the economy accounted for by Federal, State or local governmental expenditures.

Key issues of the coming decade, then, appear to be how to continue a satisfactory balance between private and Government spending, between compensatory fiscal policy and relative price stability, between modest fluctuations in money rates and our balance-of-payments problems. These are all developments which have generally characterized two different political administrations and a decade with no Korean-type wars. The real questions for the decade ahead, thus, must center around what have been the successful elements of fiscal policy during the past decade, in what way will our problems differ in the next 10 years, and what specific improvements appear warranted for the future.

Statement by Kenneth E. Boulding, Professor of Economics, the University of Michigan, Ann Arbor, Mich.

The problems of fiscal policy can be divided very conveniently into the qualitative and the quantitative, which are, of course, not unconnected. This forms a useful division. On the quantitative side we have the problem of the impact on the economy of Government expenditure and receipts of different sizes. Closely connected with this is the problem of the impact of the national debt, in regard to its overall magnitude. I think a strong case can be made that at the present the national debt is dangerously low, as it is about the same proportion of the GNP that it was in 1929. It may well be, therefore, that we could run into a serious deficiency in the total volume of Government securities in the fairly near future, and a study of the nature of the demand for Government securities and the place of these in the financial system is very urgent. I suspect myself that we probably need a fairly sharp increase in the national debt, perhaps a doubling within 10 years, if we are to avoid serious deflation and unemployment. However, this is a hunch not based on any careful study, and as far as I know the studies which could confirm or deny such a proposition have not been made. On the quantitative side also, the possibility of the impact of disarmament and a substantial reduction of Government should also be carefully considered, although a fair amount has already been done on this problem (see, for instance, the book "Disarmament and the Economy," edited by Emile Benoit and myself, Harper and Rowe, 1962).

On the qualitative side perhaps the most urgent need is a study of the impact of the tax system on investment and on business decisions. A fair amount of work has been done on this in the past, but it is by no means conclusive. There is a good deal to suggest that the level of investment, and especially the direction of investment in the United States, is inadequate to meet what might be defended as an ideal rate of growth, and that the tax system has something to do with this deficiency.

The problem of how far the tax system is cybernetic; that is, self-adjusting for movements of inflation and deflation, is something also that needs more investigation, particularly with a view to suggesting ways in which the automatic stabilizing effect on the tax system might be increased.

Another problem which has been somewhat neglected in the past is the problem of the impact of the tax system on the price structure, and especially the problem of the extent to which the tax system might be used in order to prevent a rise in prices and wages under the impact of rising employment. One of the most difficult problems which the American economy faces is that we do seem to run into inflationary pressure on prices and money wages at a point in the economy which is considerably below what most people would regard as ideal output or an ideal level of employment. If we are to have full employment without inflation, we have to develop social inventions which will permit us to control the general level of prices and wages without interfering too actively in the determination of particular prices and wages. The tax system could well be used as an instrument of this kind; for instance, discriminating taxes which penalize increases in incomes which are clearly due to a rise in prices or money wages. It may be, of course, that the technical difficulties of a plan of this kind are too great; nevertheless it deserves a careful and sympathetic study.

STATEMENT BY JAMES M. BUCHANAN, PROFESSOR OF ECONOMICS AND DIRECTOR, THOMAS JEFFERSON CENTER FOR STUDIES IN POLITICAL ECONOMY, UNIVERSITY OF VIRGINIA, CHARLOTTESVILLE, VA.

The recognition that fiscal policy and the Federal budget must be considered in the context of a growing economy has been an important step forward. This involves the recognition that existing tax and spending institutions, even if unchanged, will produce substantially differing results through time. Given the fact that the built-in flexibility in revenue yields is substantially high, largely due to progressive elements in the tax structure, this means that economic growth will generate reductions in the Federal budget deficit (or increases in the surplus) through time, provided the rate of increase in public spending programs is kept under control.

It was, of course, on the basis of this model of reasoning that the 1964 tax cut was justified, even in the face of a prosperous economy, and in flat contradiction to the standard Keynesian precepts, which dictate the generation of budget deficits (or increases in deficits) only during periods of recession. It was argued, with some legitimacy, that the stimulating effects of the tax cut (increasing the deficit) would be such that budget balance would be more quickly attained than if such stimulatory action had not been undertaken. It was on this argument that the talk was of budget balance by 1967, etc. The important point in all this is that these results will happen only if expenditures are maintained at current levels or at least kept under strict control. The argument that increasing the deficit is the quickest way to reduce and to eliminate the deficit in a growing economy becomes nonsensical without strict expenditure controls.

It also becomes nonsensical if, before budget balance is attained, taxes are again reduced, again increasing the deficit. And, given current opinion, this seems the more likely danger. The argument for the tax cut in 1963 and 1964 will have been largely vitiated if taxes are cut again in 1965, in terms of attaining budget balance.

But this raises the question: On what basis is it likely that an argument for 1965 tax cuts can be based? The answer is to be found in the full-employment budget analysis that you mention in your letter. The idea that has been developed in the last three economic reports is that the Federal budget should, ideally, be arranged so that revenues would match expenditures, approximately, at the level of full-employment national income, or potential GNP. And, so the argument goes, we need not be concerned about deficits so long as this overall rule is followed.

In my opinion, the reasoning here is deceptive, and likely to lead to serious consequences. It is sensible to consider the norm of budget balance at that level of employment which will maintain reasonable stability in the level of prices. The danger is that, if no attention is paid to the level of prices in the budgetary criterion, the full-employment surplus analysis becomes a straightforward mechanism for generating continuous inflation. The steps would be as follows:

First, the argument for and the enactment of the 1964 tax cut on the basis of the full-employment surplus argument.

Second, the probable failure of the tax cut to generate employment sufficient to attain the target rate of 4 percent unemployed.

Third, the repeated argument that still additional stimulation would be needed to attain the target rate of 4 percent.

Fourth, further tax cuts (and/or expenditure increases) in 1965.

Fifth, failure of the tax cut to attain target levels of employment, and so on continuously.

What is missing here, and in most of the pronouncements of the Kennedy-Johnson economists is a recognition that, given the current institutional arrangements in the American national economy, there may be a basic conflict between the objectives of securing full employment to the 4-percent target level and the maintenance of price-level stability, quite apart from balance-of-payments problems. By paying undue attention to the employment objective to the exclusion of the monetary objective, we stand in some danger of generating serious inflation over the next decade.

This is not to suggest that full employment and monetary stability must conflict. Proper policy measures with respect to the institutions of wage setting will make these jointly desired objectives fully compatible. My point here is that exclusive concentration on the employment objective tends to blind us to the necessity of reforming the institutions that might generate the conflict. Even in a short-run context, however, decisions to accept inflation as a "price" for attaining full employment can only be frustrated, working at best for one dose, after which all the same problems of conflict again arise.

The lack of appropriate attention to monetary objectives is accompanied by a failure to recognize the functioning of monetary instruments. In the discussion of the tax cut, and the ensuing deficit increase, little or no talk was heard about the results of the action being almost wholly dependent upon the manner in which the deficit is financed. This is all important, but the rather naive Keynesianism represented in some of the pronouncements seems to have overlooked the point completely. Stimulating action by the creation or increase of the deficit may be wholly offset by the monetary authorities if they choose to finance the deficit by borrowing from the public. If deficits are increased for the purpose of stimulating the economy, they should be financed, ideally, by creating money, and, practically, by something as near to this as possible. You simply cannot have your cake and eat it too here. You cannot get economic stimulus from a deficit, and then prevent the inflationary consequences by raising the funds with tight money. The administration in 1963–64, in its totality, including the Federal Reserve, never seemed to quite make up its mind on this point.

Personally, I am a strong proponent of achieving macroeconomic objectives (high-level employment, price-level stability, adequate growth, international balance-of-payments equilibrium) through changes in our monetary institutions. I should like to see—

1. Floating exchange rates, this allowing domestic problems to be divorced from international trade patterns.

2. The adoption of a fixed rule of monetary action. Perhaps the currently discussed 4-percent increase in the money supply per year would be best.

3. The explicit directive by the Congress to the Federal Reserve authorities to follow this rule.

4. Budget balance as the rule for the Federal budget, a rule to be relaxed only during severe depressions, which would not happen, given the operation of the monetary rule.

5. If the above combination of policies did not produce satisfactorily full employment, action on a whole range of areas to introduce greater wage and price flexibility, including—

(*a*) Repeal of minimum wage legislation, perhaps the most important single cause of the low level of employment now.

(May I, with the strongest possible plea, urge sanity here? At least, do not increase the minimum wage or expand coverage. To do this in the face of serious unemployment concentrated among the unskilled is simply absurd.)

(*b*) Repeal of Federal wage setting powers on Government contracts, which acts in the same way.

(*c*) Restrictions on wage-setting powers of large labor organizations.

(*d*) Programs of retraining, education for skills.

(*e*) Subsidies if necessary to encourage mobility.

(*f*) Rigorous enforcement of antitrust laws.

I do not consider economic growth an overwhelmingly important objective, although, of course, the relevance of the growth objective in certain areas of policy (taxes) must be acknowledged. But undue attention should not be paid to economic growth per se. In part, this statement is based in my firm conviction that, if the above set of policies were to be carried out, we should have a vastly accelerated rate of economic growth as a result.

Over the long term, I should hope that some share of collections from the Federal income tax could be returned to the States where collected, in bloc grants, on the Canadian model.

The most important revision in the tax structure, in my opinion, is the need to simplify the income tax, to get to an adjusted gross income tax if possible, and to reduce the rate of the corporation income tax.

Statement by William F. Butler, Vice President, the Chase Manhattan Bank, New York, N.Y.

I am sure that others have stressed the importance of gearing fiscal policies to the objectives of prosperity, growth, and price stability, so I shall devote little attention to this important matter. Instead, I should like to raise a series of questions which appear to me to be important within the framework of an overall fiscal policy designed to combat both recession and inflation.

First, there is the question as to how our present tax system impinges, and should impinge, on consumption and investment. This is, of course, a broad and controversial question, involving primarily the question of the incidence of the corporate income tax. However, there are also questions as to how far it might be desirable to go in using tax concessions to spur investment at home or abroad, or to encourage research and development or training and retraining activities to contribute to the antipoverty drive.

Second, there is the growing problem of the relationship between Federal, State, and local taxing and spending. Should the Federal Government collect taxes and return them to States and localities? Should the device of tax credits be used to support local expenditures for education and other matters?

Third, there are questions as to whether steps to simplify Federal taxes might not yield significant gains in terms of both equity and the stimulus to private activity from lower rates. This gets into the complex area of broadening the tax base.

A fourth question relates to the proper balance as between direct and indirect taxes. This is related to the previous questions, and yet a separate consideration of the merits of a broad value-added tax as against incomes taxes might be useful.

Fifth, what steps could properly be taken to reduce the burden of taxation on small business? I believe we face a problem in this country of providing greater incentives for people to go into business for themselves, and of providing an environment more favorable for small- and medium-sized businesses.

These are all quite conventional questions, and yet in each case very little solid research has been carried out. The studies underway by the National Bureau of Economic Research and by the Brookings Institution may shed light on these and other areas. Their findings might usefully be brought to the attention of the Congress.

To turn to less conventional matters, I would offer the following suggestions as to areas of investigation which might prove interesting:

(1) Could cyclical variations in business investment in plant and equipment and inventories and consumer investment in durables and housing be minimized by some form of tax credit device? The idea would be to grant special tax credits for such investments in times of general economic slack and remove the credit as business approached full-capacity operation.

(2) Would it be desirable to provide tax credits to encourage private investment in the less-developed nations?

(3) Could greater use be made of Federal guarantees to encourage private investment in such areas as urban renewal and rehabilitation, small business and investment in the less-developed nations? The success of the FHA guarantee program suggests that similar programs might work in other fields.

(4) Should not the feasibility of tax credits to encourage education be explored? Recent economic research has assigned an important role to education as a factor supporting economic growth. Since there is a major problem of securing teachers, might not a tax credit to people entering that field be appropriate?

As a final comment, I should like to raise the question as to proper relationship between fiscal and monetary policies. It seems to me that this is one of the very important issues in economic policy which received too little consideration. Some of the questions are quite clear: To what extent do fiscal and monetary policies conflict or supplement one another? How can the Federal Government achieve a proper coordination between fiscal and monetary policies? Is there a real conflict between domestic and international policy objectives? While there has been discussion of these and other questions in this field, I feel that the Nation is far from a consensus.

STATEMENT BY ARTHUR F. BURNS, PROFESSOR OF ECONOMICS, COLUMBIA UNIVERSITY, AND PRESIDENT, NATIONAL BUREAU OF ECONOMIC RESEARCH, NEW YORK, N.Y.

I should like to express the hope that the recent tax law may prove to be the first step in a long-range, continuing process of tax reduction. Our Federal tax system is highly productive of revenue. When our economy grows at something like a normal rate, it is reasonable to expect that the existing structure of tax rates will add about $5 or $6 billion a year to Federal revenues. This means that we could reduce tax rates every year, or nearly every year, and still have sufficient revenues to meet any modest increases in Federal spending that may be needed. I can think of no policy that is better designed to stimulate the growth of our economy than a continuing policy of modest, year-by-year reductions of tax rates. This is, in effect, what Japan has done in the postwar period, and the policy has worked remarkably well in that country. The policy that I speak of implies, of course, that the growth of Federal expenditures will be curbed effectively.

In another 2 or 3 years, if the Federal budget is again approximately in balance, we will be able as a people to embark prudently on a systematic program of annual tax reductions. But in order to do that, plans will have to be worked out in some detail, and we will need to strive for a national consensus on the issue. There is a need for molding a truly long-range tax policy, whether along the lines that I have suggested or along some other line. I am convinced that our national tax burden is still too high. Revisions of the tax structure as well as systematic rate reductions will be needed to enable our economy to flourish and advance as it both can and should.

Statement by Sam B. Chase, Jr., Senior Staff, The Brookings Institution, Washington, D.C.

1. FEDERAL TAX POLICY IN GENERAL

As I see it, one of the major aims of Federal tax policy in the years ahead should be to maintain and increase the degree of reliance on the Federal individual income tax. Further opportunities for tax cuts should be used to get rid of inferior taxes and the proposal for excise tax reduction is a welcome step. Integration of corporation and individual income taxes and a much stiffer tax on long-term capital gains are badly needed.

2. INTERGOVERNMENTAL RELATIONS

The President's Task Force on Intergovernmental Relations is reported to have recommended a system of sharing a substantial fraction of Federal income taxes with the States on the basis of population.

State and local tax systems are, by and large, bad because they are based so heavily on property and sales. State and local government expenditures will continue to mount faster than those of the Federal Government (barring a need for accelerated defense expenditures). Without Federal help, State and local sales and property taxes will increase rapidly. The logic of good taxation requires that the Federal income tax be allowed to assume an increasing, not diminishing, role in the overall revenue structure even though direct expenditure increases will come primarily at lower levels. I strongly favor tying no strings to additional Federal money distributed to the States (except, perhaps, specification that the funds cannot be used for the already overblown highway system).

It is sometimes argued that sound fiscal practice requires that money be raised at the level of government where it is spent. In this case, the objection does not seem relevant. The present State-local tax structure is heavily loaded with bad taxes, and this feature loads the dice against public expenditure. Business interests, attempting (justly, I believe) to escape or minimize excessive and unjustifiable burdens, especially from taxes on property and purchases subject to sales tax, present an effective lobby against expansion of State-local spending. In other words, the unsound basis of State-local taxes distorts decisions because expenditure increases are limited, not by public willingness to accept further increases in efficient taxes, but by public willingness to put up with increased burdens from frightfully bad taxes. In any event, a grant program of $5 billion per year or so would still leave considerable pressure on lower levels to levy additional taxes after the first year or so of operation.

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3. COUNTERCYCLICAL FISCAL POLICY

The belief is widespread that the income tax reduction of 1964–65 demonstrates a turning point in fiscal thinking in this country—a departure, at long last, from the conventional wisdom of balanced budgets.

I worry that this may be overdone. One gathers that the OECD and other international agencies will push strongly for use of fiscal devices to promote internal stabilization, leaving monetary policies free to deal with international balance-of-payments problems. What safeguards are there against multilateral promotion of budgetary deficits with ever-mounting public debts and upward pressures on interest rates? In the absence of a real solution to the apparent shortage of international liquidity, competitive deficit policies seem a real threat.

4. DISCRETIONARY TAX POWERS FOR THE PRESIDENT

This is regarded by some as the proper next step in dismantling the conventional wisdom. The main problems here are twofold: How effectively can discretionary changes in taxes be utilized, and how much danger is there that political pressures will produce unsound utilization of them. On the first question, I don't think we know enough yet to argue that discretionary taxing powers would be particularly advantageous, because the effects of tax changes are too poorly understood. Adding another highly imperfect implement to the present tool kit has little advantage. And it does present the opportunity for misuse—a danger that should be run only if the possible gains are significant. Furthermore, the spending decision would be complicated if the President had direct power over taxation.

For example, he might choose to raise taxes at a time when Congress, if it had the initiative, would pare expenditure programs instead.

Statement by Morris Cohen, Associate Editor, Fortune Magazine, and Professorial Lecturer, St. John's University, New York, N.Y.

The history of the past decade shows how long it takes for simple notions in fiscal policy to obtain wide acceptance. It is to be hoped that fiscal policy can make a better contribution to economic growth and stability in the next decade than it has over the past.

THE SIZE OF TAX CUTS

It is now widely agreed that given the massive tax cut of 1964, there is little room for fiscal maneuvering in 1965. Granted that current and prospective trends over the next half decade in defense and space outlays suggest at most a leveling out and more likely a slowly declining trend, perhaps $1 to $2 billion a year, civilian outlays on the administrative budget basis could accordingly rise as much or more than this decline. The consequence of these two factors, as almost everyone now knows, is a tendency for revenues to rise much faster than outlays. This much professional opinion grants almost unanimously and recognition of tax cuts as a tool of public policy has a widespread bipartisan support.

The broad fiscal policy issue for the future, however, focuses on the wisdom of, and the risks entailed in, a massive turn in fiscal policy such as occurred in 1964. In fact, one of the analyses urgently required is how much of the success of the 1964 tax cut is due to the fact that Government outlays have been held under considerable restraint. One wonders what would have happened had the international situation become less favorable, fostering a need for suddenly larger defense outlays. One also wonders about the capital goods response, as evidenced by the surge in manufacturing capital appropriations at least through the third quarter of 1964, and its potential aftermath. Thus, one of the major issues for fiscal policy in the next decade is the size of the fiscal package that should be enacted each year. There should be an analysis of the possible extent of the fiscal stimulus over time, compared to the risks that are involved. In other words, should a $12 or $13 billion tax cut be enacted in an election year, or should it be broken up into a series of smaller pieces and spread out over time? How do the economic benefits compare? Would the smaller cuts be less likely of congressional approval? Would they be easier to reverse if something went wrong?

Monetary policy has been lauded in the past because it moves in small steps that can be reversed without a major break in the momentum of the economy. Fiscal policy, so far, has been reserved as a blunt instrument. Now that tax cutting has been accepted as a tool of policy, even without the necessity of reconversion from a war or semiwar economy, studies of future fiscal policy should be conducted with an eye on adapting it for smaller, and more frequent, use.

FUTURE IMPORTANCE OF FISCAL POLICY

At the same time, fiscal policy may be called upon to player a larger role at times than at others. For example, it was once argued that the period 1960–65 would be one in which private demands would be lagging, and a tax cut was first mentioned in mid-1962 as one that needed immediate implementation. History shows that fiscal policy was already playing an important role in 1962 and 1963, via large increases in Federal outlays. The more interesting question now is the strength of private demands during the next 5 years. Will fiscal policy be called upon to play a larger role than it has in the past? Will Federal expenditures, aside from defense and space, be strong enough to take the place of some private demands that may turn out weaker than some now anticipate? Will further tax cuts of moderate dimensions be sufficient to keep the economy moving steadily forward until the decade of the 1970's?

PLANNING FEDERAL OUTLAYS

The Joint Economic Committee should play a leading role in advocating the planning of Federal outlays, in broad terms. Business planning for the medium term, say the next 5 years, is widespread. It is high time that the Federal Government, with its huge outlays, do the same thing. The Defense Department, of course, outlines its thinking for the next 4 years in confidential and secret reports to congressional committees. The Bureau of the Budget has been talking about establishing budget projections for 5 years ahead, but little progress has been made. At the end of the Eisenhower Administration, it even published a report on the outlook for Federal spending in 1970, and the Committee for Economic Development has also issued a similar report. While no one wants to take away the congressional prerogative of approving the spending of each Federal dollar, fiscal policy cannot play a proper role in promoting the steady growth of the economy without a comprehension of the future trend of spending. Otherwise, fiscal policy is reduced to ad hoc measures that can sometimes backfire in their economic effects.

The Joint Economic Committee can point out to the legislative branch the necessity for long-range planning of outlays, and can begin hearings on some of the problems involved. It can conduct research on individual agencies, programs, likely programs that might be developed in the years ahead, programs that might be diminishing in importance or even terminated. This would be done not from the appropriations point of view but from an economic standpoint, though the Appropriations Committees could be encouraged to extend their outlook beyond the traditional budget horizon. Perhaps most important of all, the committee can study the motion of a gradual change in Federal spending which would have the least harmful impact on economic stability. Some authorities, in fact, have argued that the business cycles in the postwar period have resulted from sharp changes in Federal fiscal policy, particularly in expenditure policy. In other words, I would stress in any study of forthcoming fiscal policy issues the necessity of analyzing them against the background of the most likely path of Federal outlays.

That would be the only responsible procedure in studying and appraising future policy proposals.

FULL EMPLOYMENT BUDGET ANALYSIS

As to full employment budget analysis, study should be conducted on the meaning of full employment. There have been too many cliches in the past about what full employment means for the fiscal position of the economy. Procedures that were developed years ago are still being used, almost by rote. New thinking is required as to the significance of full employment for fiscal policy. Alternative approaches should be studied which view changes in the fiscal position, surplus or deficit, relative to the growth and stability of the economy. It is one thing to argue that given the deficit of X billion dollars, the economy is advancing only Y percent a year, while study of the basic economic factors suggest that it could be advancing Y plus Z percent a year. It is another thing to argue that the so-called full employment surplus should be wiped out at once. Critical for fiscal policy, therefore, is the study of the potential growth of the economy, a subject that the Joint Economic Committee has pioneered in. These studies should be expanded. Fiscal policy can only be successful against the backdrop of an understanding of the pace of steady economic growth that is sustainable.

But more is needed than an understanding of the potential growth of the United States. Further study should be made of the revenue system and its relationship to economic growth. Too many statements, unverified, have been made about the elasticity of various taxes relative to economic growth. What has been the relationship of tax revenues to economic growth in the past? What will it be in the future? Do taxes run ahead of the economy, or do they just keep pace? Too little attention has been paid to these issues in the past, particularly in the passage of the 1964 tax law.

TAX REVISIONS

As to further revisions in the tax structure, I would argue for a balanced approach. This would combine the necessity of stimulating both consumption, and investment and saving. In other words, future possible revisions in the tax structure should involve additional changes in individual tax rates all along the income scale, as well as further reductions in the corporate income tax rate. The whole question of tax reform, by simplifying the tax structure, largely bypassed in the 1964 tax law, should be reviewed. The question of the potential size of the social security tax bite should be examined, along with the current excise tax structure. Study should be made of the possible role, if any, of broadly based excise taxes either at the retailers' or the manufacturers' level, and the possible trade-offs with higher exemptions in the personal income tax system.

RELATIONSHIP OF FEDERAL AND STATE AND LOCAL TAX SYSTEMS

The increasing importance of State and local government expenditures, given the current outlook for Federal analysis, is one of the most important fiscal policy issues now facing the country. There are two possible approaches to this problem, so far as the Federal Government is concerned. One is to expand the present system of grants-in-aid, introduce new grant programs, and possibly to modify the way the grants are distributed. The other is to use the Federal income tax structure as a collecting agency for the States and localities, by paying back to the States moneys collected in personal, and perhaps corporate, income taxes. In other words, study should be made of the possibilities of foregoing tax cuts to provide revenues to the States and localities for their ever-increasing programs. These were vital fiscal policy issues a generation ago, but have since been dormant. The Joint Economic Committee would be performing a major service by raising anew the issues of the relationship between Federal and State and local tax systems, and how revenues can best be collected to finance government requirements at all levels.

Statement by Gerhard Colm,[1] Chief Economist, National Planning Association, Washington, D.C.

WHAT IS FISCAL POLICY?

Fiscal policy is the policy of public finance; that is, it includes Government expenditure policies, tax and other revenue policies, and borrowing and other debt management. Fiscal policy is, however, not merely a synonym for public finance. According to a usage developed in recent decades, it refers to the conduct of public finance that takes into consideration the effects of expenditures, revenues, and debt transactions upon the general economy. Using a shorthand expression, conventional public finance is evaluated within the framework of the Government budget; fiscal policy further evaluates the same policies within the framework of the Nation's economic budget. In the development of fiscal policy, three significant changes in emphasis have taken place.

ECONOMIC GROWTH AND THE BUSINESS CYCLE

First, there has been a change in the kind of economic development to be affected by public finance policies. At the time when fiscal policy entered scientific discussion a sharp distinction was made between the long-term economic trend and the shorter term business cycle. The trend, the normal growth of the economy, was taken more or less for granted, even though theories differed about what determined the character and pace of the trend. Because attention focused on the business cycle, it was regarded as the primary task of fiscal policy to mitigate these fluctuations, thereby reinforcing a flexible monetary policy in a function which until that time was filled by monetary policy alone.

Conditions in Europe following World War II required that fiscal policy be geared to aiding reconstruction without inflation. This task did not lend itself to the conceptual separation of growth and cycle. There was no longer a cycle in the traditional understanding of the term. In the United States, also, it was gradually recognized that fiscal policy should, as a first objective, be designed to support a desirable rate of economic growth with reasonable price stability, since success in such a policy would in itself reduce the likelihood of severe fluctuations. Actually, the tax reduction measures incorporated in the Revenue Acts of 1962 and 1964 were the first deliberate application of fiscal policy not to counteract a recession but to reinforce an upswing and thereby to sustain economic growth. This new orientation of fiscal policy has significant consequences for the fiscal tools to be used.

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[1] The views expressed herein are the author's and do not necessarily reflect those of the National Planning Association.

EXPENDITURE AND TAX POLICY

When fiscal policy was first discussed in the United States during the interwar period Federal tax rates were still relatively low. When the depression of the thirties suggested the need for Federal fiscal measures of substantial size, it was obvious that expenditures had to be increased rather than taxes reduced. During World War II Federal taxes were drastically raised and broadened, and were maintained at a high level afterward to support the defense and foreign aid requirements of the cold war. High taxes have the one advantage; namely, that they can be reduced. Thus, both expenditure and tax policy have become means available for an active fiscal policy. Now, it is a matter of choice which of the two vehicles or what combination of the two can be most effective in a particular situation.

STRUCTURAL AND CYCLICAL FISCAL POLICIES

Fiscal policy during the 1930's was primarily understood as a policy of temporarily stepping up public works, including those projects which normally would be financed by State and local governments. Preference was given to programs which could be promptly terminated once recovery began to generate its own steam. In the post-World War II period the notion was added that tax rates, too, should be temporarily changed; that is, lowered in a recession but restored to their level when the recession was overcome. This was still the philosophy reflected in parts of the recent report of the Commission on Money and Credit and also in parts of the Economic Reports of the President of recent years.

Actually, a very different emphasis has emerged. Additional programs were initiated or existing programs enlarged because they were required or recommended on their own merits (e.g., strengthening national defense, the space program, measures for education, vocational training, social benefits). These were long-term programs justified on their own merits but, because of the desirability of promoting more vigorous economic growth, the initiation or the pace of the programs was speeded up and they were not associated with tax rate increases. One example of effective fiscal policy was the decision not to increase taxes in association with the increase in defense expenditures in 1961 (after the Berlin wall).

When the previously planned increases in expenditures began to flatten out in 1963—as in defense spending—and because Congress was reluctant to adopt further substantial increases in expenditure programs, the administration began to concentrate on reduction in tax rates. This tax reduction was, however, not meant to be temporary only. It was meant to be permanent so as to reduce the so-called fiscal drag, to create incentives for business investments, to reduce the unfavorable effects of unrealistically high (for peacetime) marginal rates, and to set the stage for highly desirable tax reforms. While Congress adopted only a few, but significant, measures of tax reform, the fact remains that the tax measures of the years 1962–64 marked the first deliberate effort in the United States to time tax policy in a manner designed to extend the recovery period. Thus, both the expenditure and the tax policies of these years were not of the temporary, "turn the faucet on and off" variety, but were of a structural nature while timed to contribute to sustained economic growth. This experience should not lead to the conclusion that the Government need no longer be concerned with readiness to adopt temporary antirecession policies promptly when needed. Even when progress is made in fire prevention we still want to have fire engines around, just in case . . . What has changed, and I believe permanently changed, is our view of the major problems in economic development and, correspondingly, the main task and the means at the disposal of fiscal policy.

THE EXPERIENCE OF 1961–64

If this interpretation is right the experience of the last 4 years could give us material for evaluating the result of a new kind of fiscal policy. The facts are that the annual rate of seasonally adjusted consolidated cash expenditures of the Federal Government increased by $25.8 billion from the end (fourth quarter) of calendar year 1960 to the third quarter of 1964, with greatest increases during the early part of the period. A massive tax reduction became effective in March 1964. A vigorous recovery movement began in Spring 1961, slowed ominously in late 1962 and into 1963, and again increased its momentum during 1964 with prospects of continuation into 1965. The time sequence suggests that the recovery in 1961 and 1962 was spurred by the increase in Federal programs and the strength added to the recovery in 1964 was stimulated by the expected and actual tax reduction. If fiscal policy provided the stimulus, it was successful in that the private sector increased by as much, if not more than, the Government or, rather, the Federal sector. More significant than the pace is the duration of recovery which appears to be assured into the fifth year.

Nor did this fiscal policy have unmanageable effects on the budgetary situation itself. While the level of Federal expenditures increased by $25.8 billion from the fourth quarter of 1960 to the third quarter of 1964 and tax liabilities were reduced by $14 billion, the receipts-payments relationship of the consolidated cash budget changed from a small surplus—$2.4 billion—to an officially estimated deficit of $3.5 billion for fiscal 1965. This means that the tax base increased by so much that the Federal tax yield offset a large part of the increase in expenditures and reduction in tax rates. (At least parenthetically I would like to say that I do not regard tax reduction as a means for "balancing" the budget.)

Federal consolidated cash budget

[In billions of dollars]

	4th quarter, 1960	1964		1965 [1]	
		3d quarter	Change from 4th quarter 1960	Fiscal year	Change from 4th quarter 1960
Payments	96.8	122.6	+25.8	122.2	+25.4
Receipts	99.2	112.6	+13.4	118.8	+19.6
Surplus (+) or deficit (−)	+2.4	−9.9	−12.3	−3.5	−5.9
(Change in tax liabilities [2])					(−14.0)

[1] Estimate: "Review of the 1965 Budget," October 1964.
[2] Revenue Acts of 1962 and 1964, plus change in depreciation guidelines (Treasury calculations based on 1963 income levels).

NOTE.—Detail may not add to totals because of rounding. Seasonally adjusted quarterly totals converted to annual rates except for fiscal year 1965. Third quarter 1964 payments were probably increased by extraordinary factors.

It is true that the public debt increased during the period, as also did private debt. But more significant than the increase in dollar terms is the fact that the public debt declined as a percent of GNP from about 58 percent to about 50 percent from the end of calendar year 1960 to midyear 1964. This seems to suggest that the fiscal experiment of the years 1961–64 was highly successful. Nevertheless, to regard first the increase in program expenditures and then tax reduction as the main causes of the long recovery is a highly plausible but unproven hypothesis. What can be said within the limits of certainty of any causal attribution in economics is that fiscal policy has made a significant contribution to the degree and duration of recovery of this period. This leaves open the possibility that there were other contributing factors and that the same policy may not have the same results under other circumstances. What then follows from this analysis of the past for the future?

FISCAL POLICY FOR 1965 AND BEYOND

At the time of this writing (October 1964) the American economy is moving with a momentum which promises continued expansion well into 1965. The second phase of the tax reduction under the Revenue Act of 1964 has been largely anticipated but will still provide a modest further stimulus. While Federal expenditures in calendar year 1965 (cash basis) are likely to be a few billion above those for 1964, a generally restraining budget policy is assumed to be continued for the next fiscal year. Continued increases in consumer spending, business investment, and State-local outlays are expected. Increase in business investments and residential construction in 1965 are, however, likely to be less than that for 1964.

We expect prices and costs to rise somewhat more in 1965 than in the previous year. This rise is, however, not likely to be of threatening magnitude and should not be taken as an indication that demand is "overheated." The current rise in raw materials prices and current wage developments may result in a general increase in prices just as the pace of economic activities slackens. On the other hand, were monetary policy tightened at this time to combat the price and wage rises it might also become effective several months hence just as the pace of activities slows.

The forecasts of GNP for 1965—around $660 billion in current prices might be a plausible estimate—if converted into constant dollar terms suggest a slowing down of the rate of growth during the year, although there is at present no indication that a recession is "around the corner." This may, however, indicate the probability of some increase in the rate of unemployment during 1965, unless new policies are adopted.

In our economic system, a slowdown in the rate of growth involves a threat that aggregate demand—by consumers, business, and Government—will not rise in line with our rapidly rising economic potential. We face the phenomenon—rightly emphasized by the Council of Economic Advisers and other economists—that, with rising income and production, the yield particularly of income and profit taxes is rising faster than expenditures under given budgetary policies. We are likely to encounter later in 1965 a flattening out of growth similar to that which in 1957 led into the recession of 1958, and that in 1963 which presumably was prevented from turning into a recession by the tax reduction of 1964. If the weakening of economic growth expected by most analysts should materialize it is likely that a more stimulating fiscal policy will be needed next year. It would be hazardous to predict now the exact timing and size of needed stimulation. Nevertheless, considering the leadtime needed to initiate such policies, I believe that it would be prudent to consider now what the next steps should be.

It has been estimated that, under normally expanding income and production, Federal revenue will increase by about $6–$7 billion per year during the next few years (without change in tax rates) and that the built-in increases in Federal expenditures will amount to about $2–$3 billion per year. This gives a net increase in revenue of $3–$5 billion. Assuming that the relationship between expenditures and revenues in the base year is in accord with a policy of support of noninflationary growth, it follows that there is room for some expansion of Federal spending programs, some additional grants to State and local governments (as proposed by Walter Heller), some reduction in tax rates, or some combination of the three. A policy of debt reduction in combination with a restrictive monetary policy would be desirable in an inflationary situation of overheated demand. While we should always be on the alert to recognize promptly the development of demand inflation, it is not foreseen at present.

There seems to be an executive and legislative consensus that the next step in fiscal policy should be the elimination or at least substantial reduction of some of the so-called nuisance excise taxes in the coming year. Such a step would be a desirable tax reform and also would give some support to economic growth. This is especially so as the alternative—namely, the initiation or expansion of truly worthwhile programs, either by the Federal Government or indirectly through grants to States—takes time for preparation and initiation.

I cannot, in this brief essay, amplify the criteria for appraising the economic and social priorities for additional or expanded programs, transfer of funds to State and local governments, and further tax reduction; especially important for this appraisal is the course of the international situation and the defense budget requirements for the next few years. There is no general superiority, e.g., for a policy of tax reduction over a policy of program expansion or vice versa. Consideration of priorities among the alternatives should be undertaken with a mind open to the requirements of a particular time.

Being unable to enter into a detailed argument within the limits of this essay I want to state as my personal opinion that I would place high on our priority list programs for broadening and deepening the war against poverty. Well selected social programs (education, retraining, relocation allowances, etc.) are desirable not only for social reasons but also because they are likely to contribute to increased labor productivity and to a broadening of our mass market. Of equal urgency are development programs like oceanics, promotion of basic research, weather control, desalination, control of pollution in air and water, mass transportation, and urban renewal which would have a high leverage effect upon private business investment. If a continued high rate of economic growth is attained, execution of such social and development programs by no means excludes the possibility of future reduction in tax rates, some sharing of tax yields with State and local governments, and a continuing reduction of the size of the public debt in relation to a growing GNP. These programs and other aspects of a fiscal policy in support of sustained, noninflationary economic growth should be related to long-term objectives, such as international competitiveness and expansion of mass purchasing power in accord with the growth in productive potential.

Actually, new programs proposed by responsible groups are so numerous and so important that in the Executive Office there should be a staff whose duty it is to screen and evaluate these programs. The evaluations should be in terms of technological soundness, general economic impact, manpower requirements (particularly of specialized skills), impact on the Federal budget, opportunities for private investment, and effects on international relations. Only such extensive evaluation will make it possible for the Budget Bureau and the Council of Economic Advisers to make recommendations to the President which consider long-term development programs, taxes, and debt management within the frame of desirable economic developments as a whole.

Assuming an excise tax reduction early next year, I would venture to guess that a carefully selected and carefully phased increase in social and development programs can make, dollar for dollar, a greater contribution to economic growth than a further income tax reduction in the next few years. And I stress that by "contribution to economic growth" I mean not only just removing any so-called fiscal drag but making a positive contribution to economic growth. However, I also would guess that another tax reduction may be called for before the end of the decade. To help assure the greatest effectiveness of this measure, it would be highly desirable if in the meantime a more rational Federal-State-local fiscal arrangement could be worked out to avoid a situation in which Federal tax rates are reduced while State and local rates are forced up.

ANTIRECESSION MEASURES

I believe that a successful fiscal policy in support of economic growth could mitigate periodic downturns in production and incomes. What is likely to continue are fluctuations in the rate of growth. Nevertheless, we cannot be sure that we always will be successful in sustaining a desirable rate of growth and preventing recessions or depressions. Therefore, it is a demand of prudence to make arrangements by which prompt adjustments in fiscal policy as well as in monetary policy can be made when needed.

It would be desirable if the annual requests for appropriations included contingency recommendations for programs that might well be speeded up in case of a recession and if provision were made for contingency tax cuts. In the case of the program speedup, both direct Federal programs and grants-in-aid (e.g., the accelerated public works) would be eligible. I presume that the appropriation committees would have to approve hypothetically the contingency appropriations. In the case of a threatening or actual recession the Joint Economic Committee would propose to Congress as a whole a joint resolution which would authorize the President to use the contingency appropriations in part or in whole. (This would give the Joint Economic Committee a legislative function for the first time.) In a similar way, the House Ways and Means and Senate Finance Committees would be asked to consider (with the advice of the Joint Economic Committee) contingency tax cuts to be adopted in the case of a recession. Again, in the case of a threatening or actual recession, the Joint Economic Committee would propose a joint resolution by which the tax cut would be activated.

The initiative to these actions would regularly come from the President with the advice of the Council of Economic Advisers in the form of an extraordinary Economic Report. The initiative could, however, also come from the Joint Economic Committee. In either case, the Council of Economic Advisers, other key Government officials, and some outside experts would presumably be heard in hearings by the Joint Economic Committee.

The purpose of this recommendation is twofold. First, I believe that an emergency program has the best chance of success if it is a speedup or extension of a going program and not a program developed from scratch or an activation of projects kept on the shelf. Second, I believe that by proper arrangement it should be feasible to act promptly through executive-legislative cooperation rather than by delegation of authority to the President.

In closing, I would like to stress again that even arrangement for such contingency action would not reduce the desirability of tailoring fiscal policy first of all to the requirements of sustaining economic growth. A healthy rate of growth is the most effective protection against recessions and depressions.

Statement by Evsey D. Domar, Professor of Economics, Massachusetts Institute of Technology, Cambridge, Mass.

Here are a few suggestions. Their presence on this list does not necessarily imply that I take a particular side on the issue.

1. Should grants to States and local governments suggested recently be given with or without strings?
2. Should a tax credit (not a reduction from taxable income) be given for educational expenses?
3. Financing social security. Income taxes are coming down and payroll taxes are moving up. The whole system becomes less progressive. Is this desirable? Should medicare and the like be financed from general funds rather than from payroll taxes?
4. Federal estate taxes. So little has been said about them lately that a fresh look is probably due.
5. Oil depletion and similar allowances. This perennial can always stand a reexamination.
6. More liberal rather than less liberal loss offsets.
7. The whole field of government participation in economic growth—education, research, etc.
8. Accelerated depreciation instead of investment tax credit. Is it at all possible to have initial allowance under accelerated depreciation varied by the Treasury depending on economic conditions?

Statement by James M. Dawson, Vice President and Economist, the National City Bank of Cleveland, Cleveland, Ohio

My first comment is that the recent Federal tax cut has been a decided success. This opinion is elaborated upon in the accompanying memo entitled "Testing the Tax Cut."

My second comment is that the Federal cash budget appears to be heading toward a balance for calendar year 1965. This will be occurring at a time when the housing and auto markets, two big users of credit, have leveled off and may very well subside a bit next year.

This in turn means that serious doubt is cast on whether next year's overall demands for credit, from public and private sources combined, will be large enough to put new savings accumulations to work. If they are not, a business setback is likely to develop.

This suggests that Federal taxes should be cut in mid-1965, with excise taxes an appropriate target. It also emphasizes the urgent need for quicker flexibility on tax policy.

Perhaps the power temporarily to raise or lower income taxes should be delegated to a Board of Seven, consisting of the Chairman of the Federal Reserve Board, the Chairman of the Council of Economic Advisers, the Secretary of the Treasury, the chairman of the Senate Finance Committee, the chairman of the Ways and Means Committee, the chairman of the Joint Economic Committee, and the ranking minority member of that committee.

[Enclosure.]

Testing the Tax Cut

(A memorandum prepared by James M. Dawson and published in July 1964.)

Query: Is the tax cut living up to expectations? And the answer: Yes. There are of course two inevitable qualifications. One is that we will never know what would have happened had there been no tax cut. The other is that the final returns are not yet in because the cut has been in effect only about 5 months.

Proponents of the tax cut predicted it would accelerate the economy. This was to show up in brisker gains in trade and production along with a lower unemployment trend. They also said all this could be done without provoking inflation, thanks to slack in the economy. They added that progress toward a balanced budget would be enhanced by the cut.

Now for a look at what actually has happened. Personal consumption expenditures were rising at an annual rate of 4¾ percent during 1963. The rate jumped to 9 percent in the first quarter of 1964 and the second quarter followed with 6¼ percent. Apparently there was some anticipatory buying in the first quarter when passage of the tax cut bill first seemed assured.

Industrial production likewise has climbed more rapidly since passage of the tax cut. Output rose at an annual rate of 6¼ percent during 1963 and the first quarter of 1964. The rate of rise then climbed to 8¾ percent in the second quarter. Similarly, unemployment in total and among married men declined a bit more rapidly following passage of the tax cut.

As for prices, the creeping climb in the consumer cost of living index has persisted, although if anything the pace has slowed since passage of the tax cut. The long period of stability in the wholesale index likewise has continued, but with a slight downward drift. Labor costs per unit of output in manufacturing have held steady through June.

And the budget? The official January forecast predicted a $10 billion deficit for fiscal 1964, but the actual figure was $8.3 billion. The latest official forecast for fiscal 1965 is a deficit of $5.8 billion, despite the lower tax rates. Overall conclusion: Available data thus far indicate the tax cut has been a success on all counts.

Statement by John F. Due, Chairman, the Department of Economics, the University of Illinois, Urbana, Ill.

It would appear to me that the most pressing fiscal policy issues (in the broad sense of that term) to come before Congress in the next decade are as follows:

1. Revision of the excise tax structure. The excise system is generally regarded as being in urgent need of overhaul, and excise reduction constitutes a major potential instrument of fiscal policy.
2. The possible use of a Federal sales tax, especially a value added tax. This issue is certain to arise, however little merit the proposal may appear to have in the eyes of many persons.
3. The need for reform of the income tax structure, in the interests of greater equity and simplification. A broader based tax with lower rates and simpler for the average taxpayer has great merit.
4. The possible need for further income tax reduction to avoid "strangling" economic growth.
5. The issue of Federal-State-local fiscal relationships. Given reasonably stable defense spending, State-local financial needs are likely to grow much more rapidly than Federal, yet the financial resources of the States and local governments are severely limited.
6. The interrelationship of the personal and corporate income taxes, an issue neglected in recent years.

42-402—65——4

STATEMENT BY ROBERT EISNER, CHAIRMAN, THE DEPARTMENT OF ECONOMICS, NORTHWESTERN UNIVERSITY, EVANSTON, ILL.

The coming decade offers a great challenge and a great opportunity to imaginative fiscal policy.

The challenge and the opportunity both stem from the potential peacetime growth of our economy. With little or no effort, we are able to increase our real output of goods and services at an average rate of 3 percent per year. With wise policies, we may well maintain a rate of growth of as much as 5 percent per year. But such a rate of growth, given our tax structure and stationary or mildly rising prices, will entail major gains in Federal revenues. And as is now commonplace to students of modern economics, however paradoxical to the layman, rising tax revenues, without comparable increases in Government expenditures, can prove disastrous for the prosperity of our economy.

The anticipated rise in Federal revenues becomes a particularly significant economic problem in view of the anticipated leveling and, hopefully, perhaps even decline of military expenditures. For since military expenditures have constituted by far the major component of Federal demand for goods and services, rising expenditures to match anticipated rising revenues will require a considerably more than proportionate growth in nondefense Government spending.

From the standpoint of maintaining full employment of all those able and willing to work, and full utilization of all of our existing resources, the economist may be indifferent as to the means of meeting this problem of Federal revenues rising relative to contemplated expenditures.

The effect on full employment would be essentially the same—at least as a first approximation—were the solution to be found in raising nondefense, Federal expenditures, transferring funds to State and local governments for increased expenditures at those levels of government, or decreasing tax rates, thus lowering Federal revenues and increasing private expenditures for goods and services. The choice among these solutions may well be dominated by political, noneconomic considerations. However, there are certain economic aspects of the issue which should be brought to light.

For the fact is that the very strength and initiative of the private sector of our economy is such as to threaten critical weakness in areas usually reserved to the public sector. In the private sector, we rely upon profit-motivated advertising to develop people's demand for things that may prove useful. We also rely upon the profit motive to bring about effective utilization of resources and a skillful, efficient, and ever-advancing technology. In most of the public sector, however, with the probable exception of the military, comparable stimuli are lacking. Thus, while from the standpoint of full employment policy the economist may be indifferent as to the choice of solution for the problem of rising Federal revenues, he may be concerned with the implications of that solution for the goal of adequate and efficient allocation of resources to the public sector of the economy.

Properly in the public sector are not only such traditional matters as education, highways, parks, and police. Rather, one may also wish to recognize all of the needs of an interdependent society for which the private sector is not likely to provide. Emerging programs for mass transportation, urban renewal, elimination of poverty, aid to depressed areas, and Government-sponsored research and development suggest some of the fields for fruitful and major investment of the public's resources. A nation as wealthy as ours can afford to eliminate in a very few years the inadequate education, the slums, and the poverty which are breeding serious social ills. It is only by doing so that we can really get to the roots of racial tensions and social antagonisms which we cannot afford to allow to fester much longer. It would therefore appear to be a prime task of fiscal policy to divert some of the vastly increasing Federal revenues, as well as possible savings in defense expenditures, to direct aid to appropriate public programs at either the Federal or the State or local levels. The particular fiscal techniques may be worked out with appropriate technical advice. They may involve some combination or mixture of Federal activity; specific Federal grants to State, local, or private activities; general revenue remissions to States and various tax encouragements of appropriate expenditures.

Turning then to specific issues raised in the letter of Chairman Griffiths, we may state the following:

1. *Future economic consequences of present trends in Federal revenues and expenditures.*—Sharply rising Federal revenues coupled with a leveling of expenditures would prove a serious drag on the economy. Unemployment would increase, excess capacity would grow, the rate of growth would slacken, and, at least on a per capita basis, income and output might actually drop.

As suggested above, however, prosperity and growth can well be maintained and increased by means of cuts in tax rates, transfer of revenues to State and local governments, or increases in Federal expenditures, particularly of a nondefense nature.

2. *Applicability of full employment budget analysis to policy determination.*—Such analysis, as discussed in recent reports of the Council of Economic Advisers, is highly applicable. Full employment and optimal growth in the future are likely to require more or less balanced growth in all phases of the economy, including the money supply and the national debt. Quite compatible with this requirement, prosperity and growth are likely to need, as well, a more or less chronic Federal budget deficit. In any event, the Congress should cooperate in facilitating a policy of maintaining a Federal budget surplus sufficiently low or, as I suggest, a Federal budget deficit sufficiently high to bring about full employment and optimal growth. Given the nature of our current tax structure, such a policy will necessitate repeated cuts in tax rates, or repeated increases in Federal expenditures or federally financed State and local expenditures. It is, of course, the full employment budget which should be our criterion, not the current budget. For any current budget may have a high deficit because of a low current level of output and em-

ployment which would be corrected by a fiscal policy providing a modest deficit under conditions of full employment.

3. *Needed analyses of the impact of past policy decisions.*—Detailed and systematic study of the effects of various major tax changes in the last decade should be encouraged. These should include analyses of the large role of accelerated depreciation for tax purposes, beginning with the Internal Revenue Act of 1954, the effect of the changes in tax depreciation initiated under the "guidelines" in 1962, the effects of the new investment tax credit initiated in 1962 and amended in 1964, and the effects of various major changes in the tax law in 1964, especially the cuts in personal and corporate income tax rates. To be recommended, in particular, is quantitative analysis in multiple-equation systems which would permit the isolation of the specific effects of various changes in fiscal and monetary parameters.

4. *Measures needed to strengthen the Federal Government's contribution to economic growth and stability.*—Of prime necessity is a renewed and dedicated commitment to the role of the Federal Government in maintaining growth and stability. It would be most desirable to educate the general public to the potentialities, purposes, and policies of the Federal Government in this direction. Public understanding would facilitate the desirable granting of authority by Congress to the executive branch of the Government to undertake, promptly, fiscal measures called for by changing economic situations. In particular, one may anticipate a repeated need to cut tax rates or to divert Federal revenues to State and local governments. It would be desirable to authorize the executive branch of the Government to take speedy, nonpolitical action, where indicated, in order to maintain a high level of employment and contribute to economic growth and stability.

5. *Desirable revisions of the tax structure.*—Desirable revisions of the tax structure would entail a combination of a general broadening of the tax base to include all forms of income and a consequent reduction in tax rates. Among loopholes in our tax structure, major by far is the gap in regard to effective taxation of capital gains. This involves, in fact, not so much the lower tax rates on "realized" capital gains as the absence of any tax at all on capital gains that are not converted to cash by sale. Taxation of all income on an equal footing, whether in the form of capital gains, profits, salaries, or wages, would permit much lower rates and a greater degree of equity for all those currently paying income taxes. A second major loophole in our tax structure, compounded by the capital gains problem, stems from the increased possibility of excessive depreciation allowances such that net taxable income may in many cases be far less than true economic income. There are, of course, many other substantial items of discrimination in favor of particular income earners; conspicuous beneficiaries are those able to reduce taxable income by the amount of percentage depletion allowances. It must be remembered that special privileges to the few are at the expense of the many and at the expense of possible misallocation of the Nation's economic resources.

It may be added, in general, that our tax structure should be revised in the direction of elimination of governmental interference in the market mechanism except for clearly defined public purposes. Study might profitably be initiated in the interest of ultimate realization of this goal.

6. *Significance to Federal fiscal policy of the increasing importance of State and local government expenditures.*—This significance calls attention to the desirability of a Federal fiscal policy which eases the problems of State and local government in securing revenues. Transfer of Federal funds to State and local governments has already been suggested and such a policy should be pursued. In a national, interdependent economy such as ours, one must be alert to a phenomenon of particularism which would lead State and local governments to spend less, individually, than is in the general interest. For example, many States and municipalities may find that the likelihood of emigration from their particular areas makes the optimum expenditure on education of the young, from the State or local standpoint, less than the optimum expenditure from the standpoint of the Nation. Put simply, to a poor State money spent in educating its own youth may appear partly wasted because its better educated people would tend to migrate and contribute to the well-being of other States. The problem has developed in particularly acute form with large scale migration of relatively ill educated and impoverished citizens from usually southern, rural areas to northern urban centers.

In summary, fiscal policy should anticipate the need for continuing or repeated measures to maintain full employment and optimal economic growth in the face of rising Federal revenues. These measures may include increasing Federal expenditures on public goods such as education, transferring Federal funds to State and local government, or cutting tax rates to increase private demand. The inherent bias of a free enterprise economy in the direction of private goods, as well as intelligent recognition of the growing importance for the national welfare of goods and services normally in the public domain, suggests that full employment and growth may best be achieved by substantial increases in useful expenditures for public goods at Federal, State, and local levels. This would appear all the more important in view of the hopeful possibility that defense expenditures will become a smaller proportion of gross national product, and perhaps even decline absolutely, in the years ahead. A policy of maintaining total demand and full employment on the basis of private expenditures and nondefense Government spending, it may be added, will reduce obstacles to the curtailment of unnecessary military expenditures.

Emphasis in the years ahead must be on maximum output and the high rate of growth that we can expect with full utilization of our resources. We must not be held back by ancient myths or false fears of price inflation. To the extent that the latter is a problem it may be met, at least in part, by reduction and eventual elimination of excise taxes as well as by measures to increase competition both nationally and internationally.

Our economic potential in a world at peace truly staggers the imagination. Realization of that potential is our great challenge and our great opportunity.

Statement by Ira T. Ellis, Economist, E. I. du Pont de Nemours & Co., Wilmington, Del.

The principal economic problem facing the country in the decade ahead in the areas of Federal revenues and expenditures is the increasing size and variety of Federal programs. I believe we should begin to shrink the size of the Federal establishment. We should review all the present Federal programs on the basis of some system of priorities. Many of them could be and should be reduced in size to bring Federal spending down to the level of receipts over the business cycle and then reduce them further to permit additional reductions in personal and corporate income tax rates, and some reduction in outstanding Federal debt.

We should reduce the scope of many Federal spending programs instituted during the depression of the 1930's but still growing; we should reduce defense spending to a realistic estimate of what the country needs; we should reduce spending for space, for atomic energy, urban renewal, agricultural price supports, public power, Federal lending programs, etc. The cuts need not be drastic in individual programs, but they should be widespread. We should go further than merely reducing waste. We should eliminate programs or parts of programs. Reduction in less desirable programs would permit expansion in more desirable areas. In these days of rapid expansion of bank credit, an appropriate use for a part of a Federal surplus would be reduction of Federal debt held by commercial banks, with corresponding release of credit for the private sector of the economy.

Reduction of Federal spending would permit further reduction in personal and corporate income tax rates, with more money left in the hands of individuals to spend for the goods and services they want, and reduced business costs. Economic growth would continue, but the pattern would change. There would be less spending for defense procurement, the Armed Forces around the world, agricultural surpluses, spectacular space programs, duplicating public power facilities, and many other Federal programs. On the other hand, there would be more private spending for food, clothing, furniture, automobiles, medical and hospital care, college education, etc. There could even be increases in State and local tax rates to provide additional funds for elementary and secondary education.

Statement by Richard W. Everett, Manager, Sales Control Department, Continental Can Co., Inc., New York, N.Y., and President, the National Association of Business Economists (1964)

In response to the request from Congresswoman Griffiths, I would like to suggest the following topics for study by the Fiscal Policy Subcommittee.

EFFECTS OF TAXATION ON ECONOMIC ACTIVITY

This is a matter of continuing interest in view of the high taxes imposed by all levels of government. Furthermore, this subject is particularly appropriate today because we are now in a position to assess the effects of the recent cut in Federal tax rates and because of the general interest in making further reductions in tax rates. I think it would be useful if the subcommittee were to study the effect of current tax reductions and, in addition, were to investigate the probable economic effects of alternate tax reduction programs in the future.

EFFECTS OF TAXATION ON INCENTIVE

The effect of taxation on incentive is obviously related to the first suggestion but has some ramifications of its own. A great deal has been said about how taxation affects incentive but most of this has unfortunately been based on opinion rather than solid fact. Furthermore, much of the past comment has been identified with one segment of society or another that has too clear a bias in relation to the conclusions. A responsible investigation of the effects on incentive, both corporate and personal, of alternative forms of taxation could be most constructive.

FEDERAL-STATE COMPETITION FOR REVENUES

State and local needs for revenues are rising rapidly. While the form in which the States choose to take their revenue is entirely in their control, the Federal Government has an obligation to be fully aware of State and local revenue problems and to take full account of them in the process of designing its own tax program. This would be a fruitful area for study.

THE COST OF THE FEDERAL TAX SYSTEM TO THE PUBLIC

The cost of keeping records for tax purposes is enormous for business, both large and small. It might be that a careful study of the subject would uncover alternative methods of recordkeeping or alternative definitions of taxable income that would allow large savings in accounting costs.

TREASURY INTERPRETATION OF THE TAX LAWS

I am told that the actual application of the tax laws leaves much to be desired. Many businessmen are uncertain as to how the Treasury will interpret the laws. I think it would be useful to investigate the extent to which the Internal Revenue Service carries out the will of the Congress in its interpretation of the tax laws.

DEPRECIATION

The Congress has made major progress (and so has the Treasury itself) in revising Federal laws and regulations that deal with depreciation of capital equipment for tax purposes. I think that a careful study of the results of these revisions might indicate that their effect on the economy has been favorable and that further changes are in order.

I hope that these suggestions will be of some help in selecting subjects for study in the coming session. I believe that serious investigation of these questions can have a most constructive effect.

Statement by William J. Fellner, Professor of Economics, Yale University, New Haven, Conn.

(1) THE THREE-WAY CHOICE: WHAT IT LOOKS LIKE AT PRESENT

An important problem with which fiscal policy will have to be continuously concerned relates to what in another paper I suggested calling the problem of the three-way choice. This arises because in a growing economy tax revenues tend to increase relative to expenditures if tax rates and expenditures are held constant. The policymakers may decide (*a*) to let this tendency become realized, (*b*) gradually to reduce tax rates instead, (*c*) gradually to raise expenditures instead; or, of course, to combine two or more of these lines of action in some fashion. What was just said relates to the growth path of the economy. Recession policies raise different questions (see 3, below); and an obvious reformulation is required in periods in which it is possible to reduce expenditures absolutely.

Views I may try to express on just how to proceed in the matter of the three-way choice over a period of many years are tentative—subject to revision—but it is perhaps not useless to emphasize that rational policymaking requires convictions on the part of policymakers as to how they would like to exhaust these possibilities in each growth period of limited duration. The attitude of waiting to see in which direction the pressures will become the greatest is apt to lead to bad results.

As for the present, it seems to me that to some extent (*a*), above, is a desirable objective. But for the time being it might turn out to be wise to make merely a small move in that direction because, as concerns the effect on general business conditions, credit policies resulting in higher interest rates would work in the same direction, as (*a*) above. Accepting a moderate rise in interest rates would have certain advantages because such a rise might enable policymakers, who are rightly concerned with our balance-of-payments problem, to dispense with the very undesirable interest equalization tax. An unambiguous case for a policy of overall monetary and fiscal restraint would develop only at lower unemployment ratios than those which we now have, though I think we have arrived at a point where driving the economy to higher degrees of utilization requires a presumption that the necessary degree of resource mobility does in fact exist (indeed, more systematic policies to promote this mobility might therefore be called for). In summary: at the present writing (October 1964) a moderate move in the direction of (*a*) would appear to be justified, but particularly if policymakers should sooner or later share my conviction that somewhat higher interest rates would be preferable to the interest equalization tax, then the move in the direction of (*a*) should be a cautious one.

Let me turn next to (*c*), above. Along the longrun growth path of the economy a gradual increase of the absolute amount of Government expenditures must be expected, unless effective national defense should become much cheaper (which to me as a layman seems unlikely). But recently—over the past 5 years—we have had rapid increases in Federal expenditures, not just gradual increases along the longrun growth path, and in the future there should therefore be room for further moderate tax rate reductions (see (*b*), above). If inflationary pressures should become greater, which I am inclined to anticipate, then tax reductions should be postponed, and for a while (*a*) should be emphasized more heavily instead. Hence it would, I think, be wrong to make promises concerning the timing of further tax reductions, and I would not be astonished if in the immediate short run even the tax-reduction program now going into effect proved somewhat oversized. But within a reasonable period some further reduction of tax rates may well become possible, coupled with a small move in the direction of (*a*) and with no significant change in Federal expenditures such as would suppress (*a*) and (*b*) in favor of (*c*).

When the time comes, I would suggest giving the reduction of the corporate income tax rate high priority, since the rate is still very high and investment is thereby reduced. Measures such as additional investment allowances and further depreciation acceleration may have certain advantages over a reduction of the corporate rate, but on the other hand their differential impact on investors of different types would seem to be more pronounced than that of a reduction of the corporate rate.

(2) TAX REFORM

This is a problem of great complexity, and I will limit myself to a few general observations.

Direct taxes are supposed to have the advantage of not favoring specific types of economic activity at the expense of others; i.e., of not having significant differential impacts. But in actual fact the differential impacts of our direct taxes are very significant. By now it has become unclear how much practical validity should be attributed to the proposition that the so-called welfare cost of indirect taxes (i.e., their pushing around effect brought about by differential impacts) is greater than that of direct taxes.

It is unclear also whether in practice it is easier greatly to reduce the welfare cost (in the foregoing sense) of direct taxes than that of indirect taxes. At any rate it would be wise to attempt to accomplish both these objectives.

Much has been said and written about measures which would eliminate some of the differential impacts—and hence of the "welfare cost"—of direct taxation. As concerns indirect taxes, the differential impacts could be substantially reduced by placing a uniform consumption-tax rate on nonnecessities, instead of leaving on the statute books the present type of highly selective excises. If the concept of necessities were interpreted broadly, that is, in accordance with the standards of a modern and wealthy community (as should, I think, be the case), then such a tax would be far from wholly nonselective. But it would be much less selective than is the present type of excise taxation; and we may repeat that in actual practice the direct taxes are also far from wholly nonselective.

It remains true, however, that the direct taxes can be made progressive in the conventional sense, while uniform consumption taxation of nonnecessities would have only one progression feature; namely, that introduced through the exemption of necessities. On the other hand, all calculations point to the fact that the lower income groups derive merely a surprisingly small benefit—one may say a negligible benefit—from the graduation of income tax rates in the conventional sense; i.e., from the rise of the bracket rates beyond the first-bracket rate. The lower income groups do, of course, derive a real benefit from the income tax exemptions—which by the way are hardly very generous—but something very much akin to these exemptions could become incorporated into a uniform consumption tax through exempting necessities in a rather broad sense of the term.

(3) COUNTERCYCLICAL POLICIES

Without trying to present an analysis of the manifold problems falling in this category, I will say that I favor relying merely on Federal Reserve policies and on the automatic stabilizers for minor swings; and that for swings requiring discretionary fiscal policies I am more in favor of tax-rate adjustments (in either direction) than of rapid adjustments of expenditure programs. The main line of argument of economists taking this position is, I think, well known.

Here I may point out that conflicts between "internal" and "external" economic objectives do complicate this matter too. For example, the foregoing list of priorities suggests that in a minor recession easy-money policies of the Federal Reserve should come before tax measures. This may turn out to be so even in circumstances such as the present, but in these circumstances a close look would be needed at balance-of-payments movements during the cyclical phase in question before a definite decision is reached. Other things equal, the effect of low interest rates on the balance of payments is likely to be worse than that of appropriate tax reductions, because capital movements are directly influenced by interest rates.

(4) GRANTS-IN-AID PROGRAMS

I will limit myself to brief remarks on criteria which in my opinion a program needs to meet in order to justify the use of Federal tax revenues for setting in motion a type of activity generally regarded as falling within the competence of State or local governments. I think one of two conditions needs be satisfied (or of course both may be).

(*a*) The country at large, as represented by Congress, may express the opinion that the activities in question serve the interests of people not living in the State or in the local unit in question to an appreciable extent.

(*b*) The country at large, as represented by Congress, may express the wish to accept the burden of income redistribution in favor of a poor region the population of which assigns high priority to this project and is assumed to have insufficient mobility to migrate out of the region.

Both these conditions can often be interpreted in different ways, with some amount of flexibility in either direction. Formulations of such criteria can provide only general guidance. But I think those favoring any given grant-in-aid program must be willing to make an argument for it in these terms, and the argument must be reasonable convincing.

Yet, when taking a position on these matters, people are frequently influenced either by their preference for the kind of taxation in which the Federal Government habitually engages over the typical varieties of State or local taxation, or by their contrary preference. I believe that such considerations should not be allowed to acquire importance. If no convincing argument can be made for a program along the lines of (*a*) or (*b*), above, then it is a corollary of this that a State or a local government should raise all the money, and in this case it is the business of the government in question to decide how to raise it. If a valid argument can be made along the lines of (*a*) or (*b*), then the corollary of this is that the Federal Government will raise part of the money by whatever methods it wishes to apply. But I would like to submit that preferences for alternative types of taxation over other types enter legitimately only after a decision is reached on the basis of criteria (*a*) and (*b*).

Statement by James W. Ford, Director, Economics Office, Ford Motor Co., Dearborn, Mich.

This is in response to the request of Representative Griffiths, in her letter of August 13, for my views on emerging issues in fiscal policy. I am replying as an individual, not in my capacity as an economist with Ford Motor Co.

It seems to me that present tax and expenditure policies, and proposals to change them, should be examined in light of the growth of Federal revenues that will result from the secular growth of the economy. The average annual increase in Federal revenues in recent years has been about $5 billion. With lower tax rates in effect, it is reasonable to expect that we shall experience somewhat faster economic growth and, consequently, a somewhat larger annual increase in Federal revenues. I am referring to the increase in revenues that will be generated by normal growth in the economy. This can be thought of as the secular component of change in revenues. In addition, of course, there will be a cyclical component of change, resulting from the business cycle—Federal tax revenues will rise by more than $5 billion in a year of cyclical expansion, and will fall or rise by less in a year of cyclical contraction.

One set of fiscal issues is connected with the question, How should the secular increase in Federal revenues be used? One use to which the secular increase in Federal revenues might be put is tax reduction. In this connection, I call to your attention the testimony on selective excise taxes given by Mr. Frazar Wilde before the House Ways and Means Committee in July 1964. Further reduction in corporate and individual income tax rates would also contribute to faster economic growth, especially to the extent that deterrents to investment and risk-taking were reduced.

Increases in some Federal expenditures will undoubtedly be required as the economy grows, and the claims of Federal programs will therefore have to be evaluated against those of tax reduction in deciding on secular fiscal policy. My main point in this connection is simply that the matter should be looked at in just that way: Which would benefit the country at large more—and do more to alleviate particular problems that arise—tax reduction, of one kind or another, or expenditure increases?

Countercyclical fiscal policy, to turn to the business cycle context in which fiscal policy is usually thought of, involves a different set of issues. I suggest that the Fiscal Policy Subcommittee might wish to give attention to the general subject of criteria for determining the timing of countercyclical fiscal action. It seems to me that a critical summary of current knowledge on this subject, and lack of it, would serve a useful purpose. On the question of what actions can be prompt enough and strong enough to be effective against recession and inflation, I think that Milton Friedman's observation of some years ago that we are inclined to take the will for the deed remains valid. In any event, a realistic look at how countercyclical action can reasonably be expected to perform in the present state of knowledge would be a useful contribution to improving our knowledge.

STATEMENT BY MILTON FRIEDMAN, PROFESSOR OF ECONOMICS, UNIVERSITY OF CHICAGO, CHICAGO, ILL.

The issues that will arise will be a continuation of those that have bothered us these past decades. The main ones seem to me to be as follows:

1. The appropriate relation between the level of taxes and the level of expenditures on the average of good and bad years.
2. Criteria for determining the fraction of national income that is appropriately spent through the Federal Government.
3. The role of income taxes versus other taxes in terms of cyclical effects and effects on long-term economic growth.
4. The desirability or undesirability of varying tax rates for countercyclical purposes and of alternative techniques for doing so.
5. The structure of corporate income taxes and their relation to individual income taxes in terms of their effects on monopoly, the concentration of economic power, and the efficiency of allocation of resources.

I have restricted these comments to fiscal policy broadly conceived and have avoided issues having to do with the equity of the tax and expenditure structure.

Statement by Richard Goode,[1] Senior Staff, The Brookings Institution, Washington, D.C.

FEDERAL EXPENDITURES, TAX REDUCTION, AND ASSISTANCE TO STATES

With economic growth, revenues from unchanged Federal tax rates will increase and will allow elimination of the deficit and the creation of a budget surplus or tax reduction, additional expenditures, and more Federal financial assistance to State and local governments. It seems unlikely that economic conditions will be buoyant enough to call for large surpluses and debt reduction over the next several years; therefore, emphasis on the other policies is indicated. The selection of the best combination of policies will pose important issues.

If the large tax reduction of 1964 is judged successful, it does not follow that further tax reductions should be given preference over increased expenditures or assistance to State and local governments. Growing Government expenditures for education, health and medical care, cultural activities, and other purposes are important constituents of a rising standard of living. The country has reached a stage of development at which we can afford to give more stress to high-quality public services and amenities, recognizing that minimum standards are no more acceptable here than in respect of private consumption.

The Federal Government can spend to good advantage part of the additional revenue obtained as a result of the growth of the tax base; however, primary responsibility for many of the functions that are essential to a high standard of living in an increasingly urban society rests with State and local governments. While most of these governments have been remarkably successful in meeting the demands on them during the past several years, it is becoming more difficult for them to obtain enough revenue to satisfy their requirements. A reduction of Federal tax rates makes it somewhat easier to raise State and local tax rates, but it does not remove obstacles due to limited jurisdiction, competition to attract business and population, and State constitutional restrictions on taxing power. State and local tax systems tend to be regressive and less responsive than the Federal revenue system to growing national income. Moreover, there are great differences among States in fiscal capacity relative to needs. These conditions suggest the desirability of channeling part of the additional Federal tax receipts to State and local governments.

Federal financial assistance might take the form of additional grants-in-aid for specific functions, general-purpose Federal grants, or Federal tax credits for State taxes. The tax-credit idea, which has received attention from specialists in Federal-State-local fiscal relations, would allow taxpayers to deduct their State income or sales tax

[1] The opinions expressed are the author's and do not purport to represent the views of trustees, officers, or other staff members of The Brookings Institution.

payments from their Federal tax liability, up to a certain amount, in lieu of the present provision allowing the State tax payments to be deducted from taxable income. The purpose would be to offer a Federal tax reduction, conditional on State action to take advantage of the opportunity of raising additional revenue without increasing total taxation. Further study and public discussion of the merits of the different forms of Federal assistance are desirable.

INDIVIDUAL INCOME TAX REVISION

The subject of individual income tax reform has attracted wide attention in recent years, and public understanding of the problems has been improved by active discussion and debate. Some worthwhile improvements were made in the Revenue Act of 1964, but the legislation concentrated on tax reduction rather than structural revision. Income tax reform still merits high priority. Provisions that call for special attention include the adequacy of the personal exemptions, the relation between the taxation of single persons and married persons, exclusions from taxable income, personal deductions, and the treatment of capital gains and losses.

EXCISE TAX REDUCTION

The Federal excise taxes do not meet high standards of equity, and they are burdensome to producers of the taxed items. For many years, proposals for changes in excises have been put aside pending a comprehensive review. Substantial reductions of individual and corporate income taxes have been made. When further tax reduction becomes appropriate, there will be good reasons for giving priority to the elimination of some of the excises and to rate adjustments. The recent Excise Tax Compendium issued by the House Ways and Means Committee and the committee's hearings have elicited information and views that will help the Congress in reaching decisions on the excise taxes. Further discussion and more study of the consequences of the excise taxes seem desirable in preparation for legislative action.

EFFECTS OF EMPLOYMENT TAXES

Employment taxes, consisting of employer and employee contributions for OASDI and railroad retirement, are now substantial and are scheduled to increase. Proposals are frequently made for further increases to finance liberalization of benefits. States levy payroll taxes to finance unemployment compensation. These taxes are often omitted from discussions of fiscal policy but can have important economic effects. A question for consideration is whether the taxes aggravate unemployment by discriminating against the use of labor relative to machinery and equipment. The policy issue is whether a more neutral method of financing social security would be desirable.

INTEGRATION OF ESTATE AND GIFT TAXES

The separate taxes on estate and gifts produce sharply different taxes on property transfers depending on the exact timing of the transfers and their technical provisions. A longstanding proposal is that the two taxes be integrated into a cumulative tax on property transfers during life and at death. Further consideration should be given to the problems associated with the separate taxes and with an integrated tax. There are also opportunities for better coordination of the transfer taxes or tax with the income tax. In addition to issues of tax equity, attention should be given to the effects of the present provisions and alternative provisions on property arrangements and investment patterns.

COUNTERCYCLICAL VARIATIONS IN TAX RATES

The Commission on Money and Credit recommended that the President be given limited power to raise and lower individual income tax rates in order to moderate fluctuations in economic activity. President Kennedy in 1962 advanced a specific proposal for legislation giving the President standby authority to make temporary income tax cuts to combat recession. Further consideration of this idea would be desirable. Attention should be given to the possibility of agreeing in advance on indexes of economic conditions that would help guide Presidential decisions with respect to tax changes. As an alternative to Executive discretion, consideration should be given to arrangements for standby legislation that could be quickly activated if needed.

IMPACT OF 1964 TAX REDUCTION

The appraisal of the impact of the 1964 tax reduction on the level of income and employment, no doubt, will have an important influence on future attitudes toward the effectiveness of fiscal policy as an instrument of economic stabilization. Certain private studies of this episode are underway. The Joint Economic Committee may wish to take steps to make sure that the Congress is informed about the progress and results of these studies and to supplement them by such further study and assembly of opinions as may be needed to give a complete account.

Statement by Crawford H. Greenewalt, Chairman, Board of Directors, E. I. du Pont de Nemours & Co., Wilmington, Del.

It seems to me that economic growth and stability are very closely associated with the tax policies of the Federal Government and, on that basis, I shall limit my comments to matters relating to individual and corporate taxation.

In the field of individual taxation, I think we all recognize that the tax laws as they relate to individuals are extraordinarily complex; so complex, in fact, that even a relatively simple tax return requires expert assistance if one is to do one's duty properly. I suspect that this has come about because the basic rate structure was inequitable, per se, and attempts have been made to alleviate the burdens imposed by the rate structure itself by creating innumerable exceptions and exemptions. It would seem to me that serious attention should be given to this situation, perhaps through studies which would balance the elimination of certain exemptions against a reduction in the rate structure. Furthermore, while the reduction in the steepness of the progressive tax rates accomplished by the recent tax law was a step in the right direction, the rates are still very high and cannot fail to affect the incentives of individuals. Certainly the forward progress of the economy is dependent basically on individual effort, and any tax structure which interferes in any way with an individual's putting out his best efforts is, in that sense, at least a drag on the economy.

Again in the individual tax field, we now have the anomalous situation that the top estate tax bracket at 77 percent is actually higher than the top income tax bracket at 70 percent. This, it seems to me, is also an inequity to which thought could well be given.

In the corporate field, you will recall that, under the tax law as amended in 1962, earnings of certain foreign subsidiaries will be taxed to American shareholders in the year when earned and not when distributed. This concept under which a taxpayer is required to pay tax on income before it is received certainly is contrary to all previous theories of taxation. It puts American manufacturers doing business abroad through subsidiary corporations at a disadvantage with their foreign competitors and, over the long run, I would think that this method of taxation would have an unfavorable effect upon the balance-of-payments position. In addition, the law is so complex that it will inevitably lead to extensive litigation which is expensive to the Government as well as to the taxpayer.

Finally, I might point out that, while progress has been made in improving tax administration as it relates to corporate depreciation, there is still much controversy between the Internal Revenue Service and the corporate taxpayer in this area. These expensive controversies add nothing to the tax revenues over an extended period of time. The Treasury Department recognized this to some extent in issuing

Revenue Procedure 62–21 in 1962. This procedure is a start in the right direction, but, in my opinion, contains some inherent defects which must be corrected if the objective of the procedure is to be achieved on a permanent basis.

Statement by Harold M. Groves, Professor of Economics, the University of Wisconsin, Madison, Wis.

I shall address myself only to the last two of the items in the list of matters of concern to the Joint Economic Committee.

As to the desirable revisions of the tax structure, it seems to me that the area of greatest neglect is the estate tax and gift tax which have received no major attention since 1942. The present law is far less productive than it should be and a revision might supply the means for some further relief for the income tax and/or the hard-pressed States. The present law is full of capriciousness and traps for the unwary, many of which are technical and cannot be spelled out here in any detail. In my judgment, we would do better to exempt transfers to spouses, to pool transfers by spouses to others, to integrate gift and death transfers, and to take better account of the time lapse between transfers.

As you may know we share Senator Douglas' views that the application of the tax system to the myriad forms of retirement income is long overdue for review. The exemption of social security benefits from the income tax base is an historical freak and the private pension system is characterized by many abuses. Perhaps it may be possible to develop some universal system for postponing tax on income earmarked for retirement.

There is merit in the idea of some broad based tax at a moderate rate preferably on adjusted gross income with minor exemptions to replace much of the Federal excise tax system and a share of the social security taxload. The latter, destined for a 10-percent levy on payrolls, must surely seem anomalous to many at a time when unemployment is our principal problem.

I hope that sometime we may try a bit of collective bargaining in taxation, perhaps a study committee representing mainly the federations of labor and the industrial and commercial interests whose mandate would call for the best compromise that could receive unanimous endorsement.

Statement by Seymour E. Harris, Chairman, Department of Economics, University of California at San Diego, La Jolla, Calif.

1. OBJECTIVES

Whatever fiscal policy is relevant in the 1960's and early 1970's will depend upon what our objectives are.[1] The obvious ones are stability, growth, full employment, and equity. On the whole, the Republicans tend to emphasize stability more and the Democrats tend to emphasize more the other three objectives.

2. RELATIVE WEIGHT TO BE GIVEN TO FISCAL, MONETARY, WAGE POLICY, AND THE STRUCTURAL APPROACH

Enthusiasm for high money rates in recovery periods is lacking. As Secretary Dillon argued in his Miami speech of October 27, 1964, the crucial attack is to get productivity up and costs down, rather than concentrate on capital movements. Exports in recent years have varied from 5 to 10 times net outflows of capital. Hence the wisdom of directing our ammunition primarily toward an improvement of our trade and service balance. Stimulation of the economy by having a rate of interest say 1 percent below what it otherwise would be might mean the savings of many billions of dollars, the cost of an equal stimulus through fiscal policy. That is to say, a reasonable monetary policy may be less costly to the Government than recourse to deficit financing. This is on the assumption that the monetary policy is not so easy as to bring about large amounts of inflation.

3. DEPENDENCE ON FISCAL POLICY

The fashion now is to depend largely on fiscal policy. This has certainly been the policy of the Kennedy-Johnson administration. Monetary policy has been reasonably easy, and, therefore, has made the task of fiscal policy to that extent less difficult. If monetary policy had been more severe, then it would have required a greater recourse to fiscal policy to achieve the improvements of the last 4 years.

4. WAGE POLICY

Another important facet of policy is wage policy. The Kennedy-Johnson administration has tried to avoid increases in wages not justified by a national index of productivity. They have tended to rely on the wage guideposts as a means of achieving this objective. Hourly wages would have risen more if this particular approach had not been used. Whereas, wage rates rose about 5 percent per year under Eisen-

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[1] I have discussed some of these issues fully in my recently published "Economics of the Kennedy Years" (Harpers).

hower, they rose only about 3 percent under Kennedy-Johnson. But there have, of course, been many wage agreements in the last few years that go beyond the limits allowed or suggested by the wage guides. For example, the longshoremen's agreement was one such agreement as is probably the United Auto Workers agreement. The United Auto Workers agreement may be justified on the grounds that the guidelines do not rule out a redistribution of gains between labor and capital. Since profits have been very high, in the auto industry, a case can be made for an increase in wages in the automobile industry beyond that which was suggested by the national productivity trends. But unfortunately, this is likely to result in other wage agreements elsewhere where the profit margins are not so large and, therefore, the impact on prices may be unfortunate.

In short, the guidelines are helpful, but they involve the President in wage negotiations to an extent that may not be wise, and the Executive is not inclined to press too hard lest labor and management be alienated.

Unfortunately, any excessive rise of wages (as for example, in the later years of the Eisenhower administration) brings forth either a rise in prices or, in an attempt to contend with resultant inflationary pressure by keeping down the supply of money, induces increased unemployment. What the Kennedy-Johnson administration has tried to do is to avoid this dilemma. Once wages rise too much then the pressure on prices becomes almost too much and the administration has to try to cope with the problem by accepting the price rise or else restricting monetary supplies and inducing unemployment.

5. THE STRUCTURAL APPROACH

Finally, there is the structural approach to the problems of unemployment. The charge has been made by Myrdal and others that the Kennedy-Johnson administration has underexploited this approach though the administration introduced such programs as area redevelopment, manpower training, vocational guidance, and antipoverty. Insofar as these direct approaches reduce unemployment, to that extent the contribution of monetary and fiscal policy may be reduced.

On the whole, the President's Economic Council has tended to stress the demand approach; that is, fiscal and monetary policy, rather than the direct approach. But more recently they have tended to stress increasingly the direct approach. Their general position is that demand is the crucial factor. They have argued in recent years that the proportion of unemployment for example, of Negroes, the young and the old has not increased, and therefore, that structural unemployment is not as large a factor as is commonly claimed. I, myself, have found that for a number of declining industries with jobs dropping by 2½ million (one-third) the losses were 8 times as large per year in 4 relatively depressed years as in 9 prosperous postwar years, an outcome pointing to the crucial importance of demand.

The effectiveness of the direct approach depends partly upon the number of unfilled vacancies. We surely need estimates of unfilled vacancies. The Scandinavians have emphasized the great contribution of the direct approach. But it should be observed that the direct approach is much more effective when unemployment is low than when it is high. It does little good to train the unemployed for jobs if jobs are not available. At high levels of unemployment, unfilled vacancies tend to be small. When unemployment gets down to 1, 2, or 3 percent, then the direct approach becomes much more effective.

6. WHAT KIND OF FISCAL POLICY?

Undoubtedly, fiscal policy will continue to play a very large part in the economic policies of the next 10 years.

Undoubtedly, tax reduction has become the most effective and in the view of many, the most desired approach to fiscal policy. This results partly from the fact that tax reduction has a universal appeal. Moreover, it is widely agreed that as the economy improves, the automatic increase of the take of taxation tends to abort the recovery. The tax cut, as against increased spending, appeals especially to businessmen and therefore, to that extent, it is more likely to be accepted. Once the policy of a tax cut is agreed to then the issue arises as to what kind of a tax cut, because different kinds of tax cuts have different effects on saving and spending.

It should perhaps be noted that in the past economists have found that for a given increase of the deficit, a tax cut does not yield as large a multiplier (or improvement of income) as does a deficit spending program.

Tax cuts, as against spending, have the special appeal because they favor private against public spending.

But at some point we may move too far in the direction of tax cuts and not sufficiently in that of increased welfare expenditures. In the light of Johnson antispending policies, the case for some movement in the latter direction is perhaps greater now than it was 2 or 3 years ago. President Johnson was able to increase welfare expenditures by cutting military expenditures, a generally approved policy. But in view of recent international developments, it may not likely be so easy to cut military expenditures further in the immediate future. And, therefore, the source of increased welfare expenditures would have to be out of additional spending rather than diversion from military outlays.

7. HOW MUCH ADDITIONAL GNP (AND FISCAL POLICY STIMULUS) TO INCREASE THE NUMBER OF JOBS?

The important problem is how much dependence on fiscal policy is necessary in order to bring about increases of employment, a reduction of unemployment, and also rising productivity. There is a considerable amount of disagreement on this point, but the evidence seems to suggest in order to yield a million additional jobs a much larger rise of GNP is necessary now than 5 or 10 years ago.

The President's Council, for example, has argued that $10 to $14 billion of additional GNP will yield an additional million jobs. This is an acceptable way of putting the problem. But if we should also think in terms of additional GNP required to offset rising productivity, finance the rising numbers on the labor market and the increases in the number of hours of work per week, and thus preclude an increase of unemployment related to these factors, we may need as much as $35 to $40 billion additional GNP per year in order to stabilize unemployment, and even more if we are to bring unemployment down to 4 percent.

8. DEBT MANAGEMENT

Another issue, related to fiscal policy, is the problem of debt management. Under Eisenhower the general attitude was to issue public securities with the major emphasis on keeping costs down rather than fitting debt policy to the needs of the economy. But such policy—for example, the large long-term issues in 1958—may be the wrong policy, because it results through the sale of Government securities in absorbing cash that was created for the private economy in a recovery phase. On the whole, the Dillon-Roosa program has been much more effective. The tendency has been not to issue large quantities of long-term securities which result in the absorption of cash during a period of recovery. Rather, the administration, though it increased issues of 5 years or more maturity by more than $25 billion, has tried through the technique of advance refunding to keep cash already in Government securities invested in these securities. The theory is to offer a higher rate now as a means of attracting these funds on the assumption that these additional costs in the next 5 or 10 years will be made up by lower rates later. Should rates in the next 5 or 10 years drop much more than is now anticipated, then the program may be costly. But on the basis of market prospects, there is much to be said for the Treasury approach.

9. EXPANSIONIST POLICIES IN RELATION TO THE DOLLAR PROBLEM

The state of the dollar is, of course, an important determinant of policy. The more vulnerable the dollar the less likely that we can get away with vigorous monetary and fiscal policies. Indeed, there has been a very large improvement in the dollar position. By the first half of 1964, the net balance on current account and regular Government capital account had improved over the first half of 1960 by $4½ billion (annual rate), a gain offset to some extent by a rise in the net outflow of private capital of $2½ billion. But even a $2 billion deficit in the balance of payments is one that cannot be sustained forever. Hence, it is important to operate directly on the dollar market as effectively as possible as a means of giving greater latitude to fiscal and monetary policy.

10. THE CONTINUED RECOVERY

The administration has shown great skill in keeping the boom growing. No one in early 1961 anticipated such a long and substantial boom, with real output rising in excess of 5 percent per year from 1960 to 1964. But it will be foolish to assume that this was going on forever. There may well be a reaction in 1965. The economy has had certain breaks. For example, we have not had the kind of inventory boom that generally prevails in such a period, and prices have been remarkably stable. But there are problems of increasing bottlenecks and wage agreements not justified by rising productivity and continued Government deficits. Yet it is not clear that even a rise of output from 78 percent in 1960 to 88 percent of capacity in 1964 means we have reached a point of likely inflation. Much depends on future rise of demand as against the increase of capacity.

Insofar as spending and rising demand, public and private, threaten inflation, we shall have to depend upon monetary and sensible wage policy to contain it. But it would be unfortunate if in the midst of a recovery yielding 5-percent rise per year we should introduce a monetary policy that would end the recovery, and particularly while unemployment is high and excess capacity substantial.

11. WE NEED MORE FACTS

(1) How much additional GNP is required to yield 1 million additional jobs? (Related is the income impact of a given cut in taxes or rise of public spending.)

(2) Should we not consider alternative Government expenditures relative to the number of jobs they yield? For example, how many jobs does a billion dollars spent on public works yield as compared to a billion dollars on medical care? This is a problem that interested President Kennedy and also Director of the Budget Kermit Gordon, and apparently there is going to be some attention paid to it.

(3) How much will providing an additional million jobs cost the Government through the spending route, the tax cut route, reduced monetary rates, or the direct approach?

(4) How far should we go in the direction of tax cuts before we begin to increase welfare expenditures?

(5) To what extent shall we depend upon direct approaches in the balance of payments, for example, the interest equalization tax, increased pressure to free capital exports abroad, more pressures on foreign countries to pay part of the bill, possible restrictions on imports or export subsidies—all of these against monetary and fiscal policy.

(6) To what extent should we pay much more attention to the cash budget rather than to the orthodox administrative budget? The present administration has made some progress along these lines and how much further should they go? It is clear that in periods of recovery, the recourse to the nonadministrative budget may well yield a more sensible policy and smaller deficits in the crucial recovery period than excessive attention to the administrative budget. Besides, the administrative budget leaves out of account very important receipts and expenditures.

(7) How do we measure the responsiveness of monetary policy? The supply of demand deposits and cash? These plus time deposits? All liquid assets? Loans and investments of commercial banks or of all financial intermediaries?

(8) How responsive is domestic investment as against capital exports to variations in money rates?

STATEMENT BY C. LOWELL HARRISS, PROFESSOR OF ECONOMICS, COLUMBIA UNIVERSITY, NEW YORK, N.Y.

1. The 1962–64 debates on tax reduction suffered from failure to consider the monetary aspects. Perhaps the Committee on Ways and Means and the Committee on Finance believe that monetary problems lie outside their jurisdiction. But one major issue was tax reduction to influence the level of employment and national income and the actual results will depend significantly upon the accompanying monetary policy. Advocates of the tax cut held out the prospect of economic stimulation which assumed, I believe, one general type of financing the deficit. Other types of financing would yield other results, yet the implications of different types of financing were not discussed.

When the determination of monetary policy rests with a group different from those who vote taxes, who can be sure of what will happen? Nevertheless, because fiscal and monetary policy are intimately related some discussion would have been desirable. As I recall, it was only after the tax bill had been passed, or virtually so, that the President, Representative Reuss, and others spoke about the role of monetary policy and the need for "cooperation" from the Federal Reserve. Would not a better basis for public understanding have been laid by including the monetary aspects in earlier discussion?

2. Reexamination of debt management might now be desirable. Much of what has been put into the record in the past is still useful. Nevertheless, a new look at debt management under the conditions of the mid-1960's could help in clarifying today's issues and perhaps in integrating monetary and fiscal policy and thinking with optimum effectiveness. Such a study touches upon some of the issues which Representative Patman's subcommittee has been considering; for example, the interest ceiling on long-term debt and the relation between open market purchases by the Federal Reserve and other actions to increase bank lending capacity (money creation) over the long run. Such problems have controversial aspects, a fact which adds to the need for reconsideration from time to time. Just as witnesses in the hearings on the Federal Reserve have criticized it for lagging behind the academic leaders in monetary analysis, many whose views on debt management were formed some years ago may not be aware of more recent developments.

3. The "fiscal drag" argument seems to me to imply something about the workings of the monetary system, something which is not spelled out or made explicit in the discussions I have seen. Yet will not results of a change in the deficit, etc., depend to some significant degree upon the responses of the monetary system? Would it not be helpful to have clear analysis of the ways in which various monetary conditions influence the results from a sharp increase in tax receipts?

4. Another subject which warrants some "spelling out" is the differences—and the similarities—in the ways in which monetary and

fiscal policies work themselves out. "Tight" money for balance-of-payments reasons and "easy" fiscal policy to stimulate business get endorsement. But how is "easy" fiscal policy financed? Do not the results depend upon more than one elasticity? What are the facts? Perhaps the matter in fact is as simple as often implied, but in any case some fuller discussion is in order. Incidentally, what does the country gain by paying interest to foreigners to hold gold?

5. Remote, indeed, seem to be the problems and possibilities of reducing the national debt. They involve both fiscal and monetary issues. What, exactly, are these issues? What significance do they have? How would retirement of part of the Federal debt compare with other means of saving and what about growth of the Federal debt? Why did the leaders in 1963 feel the need for such emphatic criticism of budget deficits?

Given the complexities, the intricacies, and the existing state of public understanding, no small amount of analysis and education are called for. Unquestionably, concern about the public debt is widespread. A committee analysis might reveal areas of agreement, those of uncertainty, and those of clear difference of view.

6. The effects of high tax rates, especially 48 percent on corporation earnings, require continuing analysis. This, I know, is easier to urge than to accomplish.

7. Public works are frequently suggested as a means of stimulating employment. But is not one reason that private and State-local expenditures on construction prove "inadequate" the level of cost? What are the effects of Federal expenditures on construction costs? Such an inquiry can never be fully satisfactory. But is it not relevant? Perhaps price indexes overstate the rise in construction costs—I certainly do not know, but I should welcome enlightenment.

8. What effects do minimum wage rates—whether dictated by social factors, employer preference, union contracts, or laws—have on employment? With accumulating evidence, can we not reduce the range of dispute about this rather important question?

9. A careful examination of past and present Federal programs should throw light on opportunities for improvement. Some have already been examined; e.g., Federal Reserve policies, urban renewal, area redevelopment. What can Congress learn from the record? How can the record of results be made more complete?

10. Western Europe, we frequently hear, has done better than this country in the last few years. How much of Europe's ability to bear inflation with such apparent ease has been due to our balance-of-payments deficit? If we had had comparable inflation, how would results for us have compared with those we have experienced?

Many other subjects might be suggested and I'm sure your other respondents will provide a long list. You can certainly contribute to the public welfare by continuing your study of this broad range of important problems.

Statement by Hendrik S. Houthakker, Professor of Economics, Harvard University, Cambridge, Mass.

1. EMPLOYMENT

Although there has been a slight improvement in the employment situation recently, I believe that this problem will continue to be a source of concern in the coming years because of the close balance between the growth of demand, the growth of the labor force and the growth of per capita output. The situation may be further complicated by a decline (or at least a failure to rise further) of defense expenditures and a possible leveling off of highway construction toward the end of the decade. In my opinion more thought should be given to possible reductions in the working week and the working year. It appears that the Fair Labor Standards Act has interrupted a reduction in the working week, which had been fairly continuous until then. As a result the American people have probably not enjoyed as much of the benefits of increased productivity in the form of leisure as they otherwise would. A reduction in the working week or working year would probably lead to a higher unit cost of labor and thereby stimulate investment.

2. THE BALANCE OF PAYMENTS

Here again, I feel that recent improvements should not lead to the illusion that the problem is on the way to solving itself. As I have argued before the Joint Economic Committee, the unfavorable international economic position of the United States is due to overvaluation of the dollar, itself a result of excessive devaluation of the leading European currencies in 1949. Since prices have risen somewhat faster in Europe than in the United States in recent years, the overvaluation of the dollar has been slightly reduced, but it is still very substantial. It shows up, among other things, in the tendency for American business to invest heavily abroad. The interest equalization tax has done a little to cure the symptoms of overvaluation but the underlying problem will remain serious until exchange rates are brought in line with competitive conditions. Although personally I still feel that devaluation of the dollar would be the best way of achieving such adjustment, this idea has met with such resistance that it might be more expedient to encourage further revaluation of the most undervalued European currencies, especially the German mark. Compared to the question of exchange rates the issue of liquidity is of quite secondary importance.

3. TAX REFORM

This is another item of unfinished business which will undoubtedly come up again. To my mind there can be no doubt as to the desirability of reform in all areas of Federal taxation, but especially in the individual and corporate income taxes. It seems that the case for individual reforms was lost largely by unfortunate Treasury tactics. By stressing the removal of special privileges violent and effective opposition was organized.

One idea which has occurred to me is that these special privileges might be more painlessly attacked by raising the standard deduction, which is now so low as to decline in importance every year. For most taxpayers a raise in the standard deduction is equivalent to a reduction in the rate schedule, but it does not take away these special privileges as obviously as a more direct approach would have done. In this connection I might also state my view that personal exemptions should be revised upward.

In the case of the corporate income tax the possibility of shifting (at least partially) to a value-added basis has been discussed recently by the Ways and Means Committee, though apparently no conclusion was reached. In view of the Common Market agreement on this subject it will become necessary to safeguard American exports to Europe by some kind of fiscal adjustment, which might well include adoption of the value-added principle. Recently announced Treasury plans in the excise tax field may also lead to a further consideration of the value-added tax.

4. QUANTITATIVE TECHNIQUES OF POLICYMAKING

In recent years economists have made considerable progress in the formulation of models designed to clarify alternative policies. Although these methods are still largely experimental they would seem to merit the attention of the Subcommittee on Fiscal Policy. In the U.S. Government some work has been done in this area, but not as yet with any great determination. The Subcommittee on Fiscal Policy could contribute to further thinking in this area by acquainting itself with what is being done and gathering expert views on what could and should be done. To avoid misunderstanding I should perhaps state that I am not directly involved in this work myself, except in that I have participated in research on the projection of consumer demand for the Bureau of Labor Statistics and have been a consultant to the Treasury on problems of revenue forecasting.

Statement by Neil H. Jacoby, Dean, Graduate School of Business Administration, University of California at Los Angeles, Los Angeles, Calif.

(Ed. Note: In lieu of a formal statement, Dean Jacoby submitted a copy of his paper, "The Fiscal Policy of the Kennedy-Johnson Administration," which appeared in the Journal of Finance, volume XIX, No. 2, July 1964. The committee staff selected two sections of the paper for publication in this compendium.)

VIII. ACTION ON EMERGING FISCAL PROBLEMS OF THE NATION

* * * Among the many salient problems one might mention, including reform of the Federal income tax structure, perhaps the largest is the adequate financing of American State and local governments. This is a problem * * * in the solution of which the Federal Government must necessarily take leadership.

A truly phenomenal development of the postwar era has been the rise in the level of State and local expenditures. During the decade 1953–62 annual Federal expenditures rose about 43 percent, while State and local expenditures rose by 118 percent.[1] Federal outlays rose at an average compound rate of about 3½ percent a year, while State and local outlays grew about 8 percent a year—2½ times the rate of growth of the U.S. economy. These trends reflected rapidly rising demands for the "products" of State and local governments—mainly schools, streets and roads, police, fire, sanitation, recreational and welfare services, and slowly rising demands for the "products" of the Federal Government, of which the dominant element has been national security.

These trends will undoubtedly continue during the next decade. Demand for Federal Government services will grow less rapidly than the economy. The postwar population "explosion" which the Nation has so far felt in its elementary and secondary school system will strike with full force the markets for higher education, housing, and other State and municipal services. Continued urbanization of this expanding population will create appalling problems for our already underfinanced and overburdened towns and cities.

The basic problem is a mismatching of the limited revenue-raising powers of State and local governments with their large and rising governmental responsibilities under the present constitutional system. Limited jurisdiction makes States and municipalities inefficient collectors of income taxes. Yet, considerations of equity as well as efficiency put definite limits on the degree to which the burgeoning demand for their services should be financed by higher retail sales and ad valorem property taxes. Our Nation is thus faced with these alternatives: increasing inequities and inefficiencies in State and local finance; rising Federal grants-in-aid to the States; adoption of some formula of Federal revenue-sharing with the States; or a reapportionment of governmental responsibilities among levels of government. What is the right course of action?

In one of his first messages to the Congress in March 1953, President Eisenhower recommended the creation of a Commission on Intergovernmental Relations, which was duly appointed and reported in June 1955. The main thrust of its advice was to leave the present division of governmental functions undisturbed, and to expand Federal grants-in-aid to the States. Subsequently, there has been an enormous growth under both the Eisenhower and Kennedy-Johnson administrations in the annual amounts of such grants and in the number of their end uses. Federal grants-in-aid nearly quadrupled from \$2.7 billion during fiscal year 1954 to a proposed \$10.4 billion in fiscal year 1964.

I suggest that further ad hoc actions to meet State and local financing crises in urban transportation and other fields by the instrument of new Federal loans

[1] Expenditures are as calculated in the national income accounts which include Federal grants-in-aid in both Federal and State and local expenditures. See "Economic Report of the President, Jan. 1, 1963," p. 241.

or grants-in-aid are inadvisable. It is time that President Johnson ask Congress for authority to appoint a special Commission of Inquiry into Intergovernmental Finance, charged with the duty of making a searching inquiry into present and impending problems in this area, and recommending long-range solutions. Such a temporary Commission would examine the basic institutional framework of intergovernmental finance. It would not duplicate the valuable coordinating functions now being performed by the permanent Advisory Commission on Intergovernmental Relations, established by the Congress in 1959.[2]

IX. RECAPITULATION

Federal performance under the Kennedy-Johnson administration has been much different from the fiscal policy pronouncements of the Democratic Party. Just as fiscal performance under the Eisenhower administration was decidedly less conservative than Republican preachments, so has fiscal performance under the Kennedy administration been more conservative than Democratic orthodoxy. In fact, this administration's proposal of a massive reduction in Federal taxation, accompanied by an effort to hold the line on expenditures, is an essentially conservative adjustment to the working of a progressive Federal tax system in a growing economy. The orthodox Democratic adjustment would be a further expansion of Federal expenditures.

The most remarkable characteristic of Federal fiscal performance under the Kennedy-Johnson administration has been its continuity with that under the Eisenhower administration. The overall role of Federal cash payments in the total spending of the economy has been maintained at an almost constant level of 19.7 percent during the past decade. There has been a persistent and massive shift toward investment-type Federal expenditures, and toward greater relative reliance upon revenues derived from commodity and payroll taxation instead of from net income and estate taxation. The automatic countercyclical stabilizers in the Federal budget have been well maintained; both administrations have used their executive powers vigorously to smooth the Nation's economic progress; and President Kennedy sought, though unsuccessfully, to persuade Congress to increase the President's powers to take stabilizing action. All of these trends are growth promoting in their effects.

Most economists will, I believe, find these trends satisfactory. But three major criticisms of this administration's record remain. First, it has not acted vigorously to curb and reduce some spending programs which on a basis of abundant evidence are not producing much social welfare per dollar. Secondly, the emphasis in its tax reduction program on personal instead of corporate tax cuts is inconsistent with its avowed aim of faster economic growth. Thirdly, it has not yet put in motion machinery aimed to resolve on a fundamental long-term basis the explosive problems of Federal-State-local financial relations, which are rising in urgency year by year.

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[2] The Advisory Commission on Intergovernmental Relations is a permanent organ of fiscal coordination, which meets at intervals, and whose members are mainly Federal, State, and municipal government officials. Cooperation within the existing institutional framework is obviously necessary; but the framework itself needs restudy and possibly redesign.

Statement by Lawrence R. Klein, Professor of Economics, University of Pennsylvania, Philadelphia, Pa.

1. Since 1962, many administration economists have argued that tax cuts are necessary to alleviate unemployment and stimulate growth in the American economy. I favor the tax cuts as steps in the right direction but doubt strongly that they are the best or only fiscal measures that should be taken. I would like to see much more exploration of alternative fiscal routes to full employment. The tax cuts have improved the situation but not brought about truly full employment. What are the limitations of such policies? I think that much more thinking is needed on the subject of public investment as a stronger policy leading to full employment.

2. Many optimistic views have been put forward about the relation between the tax cuts and the balance of the Federal budget. I think that it is unlikely that such cuts can ultimately generate enough new activity to bring the budget into balance or surplus. Talk about a future fiscal dividend seems to be unjustified yet, and a careful study with statistical models is required to put this matter right. Short- and long-run impacts of tax cutting on budget deficits (or surpluses) must be evaluated more carefully, and I would doubt that such policies are likely to turn present deficits into surpluses in the near future.

3. Some recent studies have gone far in showing how tax revenues, social insurance contributions, and transfer payments are associated with levels of economic activity and income distributions. Much less is known about the nature of that part of Government expenditures which is not wholly independent of economic events. Many expenditures are predetermined by political events over which we have no direct control or influence, but others are induced by economic matters. The latter expenditures need careful study, especially in relation to the feedback effects of economic activity on them.

4. I would not want to neglect tax reform in terms of justice, equity, and economic incentive. The tax structure often grows like Topsy, and it periodically needs review in order to rationalize it in the interests of stimulating the economy to grow at high levels of employment.

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Statement by Norman F. Keiser, Professor of Economics, San Jose State College, San Jose, Calif.

I. ECONOMIC GROWTH VIA AN ENLIGHTENED FISCAL POLICY

It would seem that one of the most important goals that the Congress might accomplish in the area of fiscal policy during the next decade is the realization of an enlightened fiscal policy. By an enlightened fiscal policy we mean one that is based on modern income theory, which is, in turn, empirically verifiable. Such a policy requires an understanding of no more than the equivalent of the basic course in economics. In comparison with past fiscal policies much can be done to realize sustained economic growth and greatly mitigate the depth and length, and reduce the number, of recessions in the American economy.

In the basic course in economics we learn that, generally speaking, there are two sides to the problem of economic growth—total demand and total supply. Total demand is the result of spending by consumers, businessmen (on investment goods), governments, and foreigners. Total potential supply depends on our supply of capital, the size and quality of the labor force, the state of our technological knowledge, the quality and quantity of our natural resources, and various social values such as our attitudes toward work, scientific progress, efficiency, etc. In the United States we have had the necessary ingredients for the attainment of a high level of output and a rapid rate of economic growth. That is, we have had a plentiful supply of natural resources; a willingness to undertake risks and a system of rewarding them; a healthy attitude toward saving and capital accumulation; an adequate supply of labor; a high level of educational attainment; well-trained scientists and engineers, and skilled labor; a healthy attitude toward work; a responsible labor force; an urge to get ahead; and a stable political system. In short, we have had the attitudes, abilities, resources, and social-political-economic characteristics that are conducive to growth.

But the high rate of growth, higher level of production, and lower level of unemployment that we are capable of achieving has not been realized. Inadequate growth can result from the failure of either total demand or potential supply to expand sufficiently. Ideally, we would like our ability to produce goods to expand at the same rate as our demand for goods. If the rate of increase in total demand is greater than the rate of increase of potential supply, inflation results. (This is true in the long run. In the short run there may be sufficient excess capacity so that the rates of increase in demand and actual output are greater than the rate of increase in potential supply without inflation resulting.) If the rate of growth of demand falls behind the rate of growth of potential supply excess capacity results, which dampens the incentive to invest. We would, in addition, prefer that our ability to produce goods and services expand at such a rate that when we are operating at full or optimal capacity we are also experiencing full employment.[1] If this does not occur we have either excess capacity or operation at full capacity of industry but not full employment of our labor force because the supply of capital is inadequate.

What all this amounts to is the fact that we wish to attain balanced economic growth in which both unemployment and price fluctuations are minimized. Whichever factor lags behind—or the growth of total demand, or the growth of total supply—will be the limiting factor on our rate of growth. If our capacity to produce goods lags behind the rate of increase in the demand for goods inflation results as we noted above. The cause is the fact that we are not able to produce enough and prices are thereby bid up. Also, as we noted above, if demands does not grow at a rapid enough rate we have both unemployment and unused industrial capacity. The unused capacity may in itself result in a reduction in the level of investment. This reduction in investment will result in not only a reduction in income and a consequent increase in unemployment, but also in a reduction in the rate of growth of our ability to produce goods. We see then that a reduction in the rate of increase in potential supply may result from inadequate demand. Thus far this has not been a problem in the American economy, but it could have been if highly restrictive policies had been continuously pursued throughout the 1960's.

II. ECONOMIC MYTHS AND ECONOMIC POLICY

The primary reason why the American economy has not experienced a full employment, noninflationary, balanced rate of growth has been the restrictive fiscal policies that were pursued knowingly and otherwise during the late fifties and early sixties. Failure to pursue the proper fiscal policy was no doubt primarily due to the attachment that the public, the Congress, and various Presidents have had to certain economic myths. Even when our political leaders have been better informed they have often behaved in terms of these myths because they thought it was what the public wanted. The economically ignorant mouth such myths as follows: Federal Government spending is inflationary; the Federal budget should always be balanced; deficits are inevitably inflationary; the national debt will bankrupt us, will be totally passed on to our children, and Government spending and debt are immoral and unproductive; expansionary or contractionary fiscal policy will not work; the Federal Government is usurping the functions and responsibilities of the State and local governments; spending by private individuals always yields greater satisfaction than expenditures by Government; Government is always inefficient and private business efficient; the self-regulating free market always provides the most efficient allocation of resources; the Federal Government is not responsible for the realization of maximum employment; the State (or local) governments can carry out all the necessary governmental functions except defense; we simply cannot afford to under-

[1] Assumed here to be 3 percent.

take given projects such as aid to education or slum clearance, etc.; the current tax load is intolerable, etc.[2]

The fact is that in each above case the situation is the reverse of the manner in which it is stated, simply not true, or subject to very serious qualification. Myths such as these will not withstand the test of economic analysis or empirical research, but because they are believed they constitute the basis for policy determination. They have been the cause of failure to adopt an enlightened fiscal policy and of outright Federal inaction. In the early fifties it was maintained that Federal expenditures were inflationary, destructive of private initiative, and were speeding us down the road of creeping socialism, and that an increase in or too high a level of the same would produce "a depression or recession that will curl your hair." Still more recently the opponents of an activist fiscal policy have argued that fiscal policy could not help the unemployed because they were structurally unemployed and not further employable. Currently the argument is that a policy aimed at reducing unemployment will necessarily aggravate our balance-of-payments problem. The structural unemployment argument has been competently refuted as the basic cause of unemployment and it is, of course, not necessary that fiscal-monetary policies aimed at achieving a higher rate of growth aggravate the payments problem.

The myths that are probably of most concern to us are those that state that fiscal policy will not work, that deficits are always inflationary, and that debt and Government spending are immoral. The acceptance of these myths led to a blind determination to balance the budget despite an unemployment rate of 5 to 6 percent. We might expect this in the twenties and early thirties but not in the fifties and early sixties, although we got it then. (Kennedy's actions certainly could not be classified as blind; rather they resulted from the acceptance of the myths by the public. He thought it was politically necessary to balance the fiscal 1963 budget.)

III. IMPROVEMENTS IN FISCAL POLICY

Despite the foregoing, certain definite improvements in fiscal policy did occur in the early 1960's. (1) Greater emphasis was placed on the use of the Federal budget in the national income and product account and the cash consolidated as opposed to the administrative budget: The national income approach is much better than the administrative budget and was first introduced in the budget for fiscal 1963. (2) The measurement of the impact of the Federal budget in terms of the full employment budget represents an exceedingly significant improvement in analyzing the impact of the level of and changes in Federal expenditures and revenues. (3) The acceptance of the tax cut in 1964 represents an extremely important advance in the Government's and the public's understanding of fiscal policy.

But the current attitude toward Government spending cannot be classified as healthy. This consideration brings us to what may be the most important problem in economic policy for 1965: Unless there is

[2] For further elaboration see my Macroeconomics, Fiscal Policy, and Economic Growth, New York: John Wiley, 1964, pp. 5–8.

a large and self-perpetuating increase in the ratio of investment to the gross national product in 1965 it will be necessary to either raise Government expenditures or lower taxes, or do some of both, to continue the stimulus provided by fiscal policy. If we are to put a substantial dent in the unemployment rate, tax reduction or expenditure increases will have to be of an even greater magnitude than in 1964. It has been estimated by competent observers that at full employment tax revenues would increase by some $6 billion per year. A tax reduction or expenditure increase of approximately this same dollar magnitude will be required each year unless there is an offsetting increase in spending by another sector. It follows, therefore, that even though the President is securing support for tax reduction and other programs by proclaiming that a lid will be kept on Government expenditures, unless he is willing to follow the alternative route in 1965—that is, push for another substantial tax reduction—that year may see a slowdown in the economy. There may, of course, be some carryover of prosperity resulting from the expansion of 1964, but unless there is a substantial increase in investment further stimulation from fiscal policy will no doubt be needed.

IV. THE SURPLUS OR DEFICIT IN THE FEDERAL BUDGET AT FULL EMPLOYMENT

The full employment surplus analysis of the impact of the Federal budget represents a very significant advance in the manner in which the impact of fiscal policy is measured. It is of further importance because it is the most plausible explanation for inadequate growth in the late fifties and early sixties. These explanations have included (1) the inadequate saving-investment thesis, (2) the structural transformation thesis, (3) the inadequate demand thesis, (4) the argument that Government regulation of business, intervention, etc., have hamstrung and restrained private enterprise, and (5) the argument that deficits have occurred and have not worked, and have in fact depressed investment in some way.

The leaders of the administration in the late fifties and the Chairman of the Board of Governors of the Federal Reserve System adhered to the inadequate saving investment, structural transformation, and ineffective deficit approaches. The inadequate saving and investment was allegedly caused by the profit squeeze.[3] None of these approaches, however, offers a satisfactory explanation for our slow rate of growth. It is futile to expect that tax reduction for investment will result in significant increases in investment when considerable excess capacity exists. Tax reduction for certain groups and corporations will, of course, increase saving, but not necessarily investment. The price paid to receive the investment that does result may indeed be very high in terms of revenue loss and the distribution of income. In addition, there is a high correlation between corporate profits and capacity utilization. Greater investment will occur with permanent increases in

[3] The alleged seriousness of the decline in the investment/GNP ratio is another issue. It is discussed in ibid., pp. 204–209, and 333–335.

The so-called squeeze on profits has been seriously exaggerated because of the correlation between capacity utilization and profits (note recent profit reports) and for other reasons. See the discussion in ibid., pp. 335–338.

demand, higher rates of capacity utilization, and higher corporate profits. In a similar fashion saving will increase as the level of income increases.

The structural transformation thesis has been substantially discredited by the Council of Economic Advisers, James W. Knowles and Edward D. Kalachek in a study for the Subcommittee of Economic Statistics of the Joint Economic Committee, and by others.[4] This does not mean that continuous attempts should not be made to retrain the unemployed and otherwise make the labor market operate more efficiently. These policies should be pursued regardless of the level of aggregate demand. When the level of aggregate demand is too low for a long period of time, however, there will be a larger number whose skills have become obsolete, those over 45 years of age will have greater difficulty securing employment, and so on. Retraining in and as of itself will not provide jobs. Fiscal and monetary policy are necessary for this.

Those who argue that deficits are ineffective fail to understand modern economics and fail to distinguish between active and passive deficits. Some critics of fiscal policy have argued that since we have had periods in which we had both deficits and declines in the GNP, fiscal policy is ineffective. Such arguments fail to recognize the fact that deficits may be caused by either a decline in the economy or by deliberate policy action. Passive deficits occur because recessions bring about a reduction in tax collections (while expenditures remain the same or increase slightly). This is a deficit by default. We might expect that its stimulative impact not be as great as that of a deliberately imposed deficit aimed at offsetting the decline before the economy drops to a low level, or one imposed on an economy that is already experiencing a rapid rate of growth. (Furthermore, the longer we wait to impose a deficit to offset a decline the larger the tax cut will have to be for full employment to be attained and the larger the necessary tax increase may be when full employment is reached.) The contention that deficits of European countries have been successful and that ours have not fails to make this distinction. These nations typically undertake antideflationary action before the decline becomes serious. They place greater reliance on discretionary action rather than place major reliance on automatic stabilizers as we have done so often. When their rate of advance merely hesitated they acted. Their deficits have been mainly deliberate and active rather than of the passive variety.

As far as the argument that Government regulation of business, etc., has hamstrung and restrained private enterprise is concerned, we have little evidence that such a charge accounts for a slower rate of growth. In fact, a case could be made contending that many Government actions (the Employment Act, banking legislation, housing legislation, sponsorship of research, the support of institutional stabilizers, and other programs) have done much to stabilize the economy, reduce risks and uncertainty, and encourage private investment.

This leaves us with the inadequate demand thesis. The inadequate demand thesis is directly related to the full employment surplus-

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[4] See the bibliography in N. J. Simler, "Long-Term Unemployment, the Structural Hypothesis, and Public Policy," American Economic Review, December 1964, pp. 985–1001.

deficit analysis. This approach attempts to measure the impact of the Federal budget by estimating the level of revenues at full employment. Since the level of expenditures is known (or more accurately will vary only slightly) the surplus or deficit is readily computed. It is this surplus or deficit that indicates the restrictive or expansionary impact of the budget, and changes in the level of the surplus-deficit that reflect changes in fiscal policy. In recent years the tax rate schedule and level of Government expenditures has been such that a gigantic surplus would result at full employment levels of production and income.[5]

As we noted before total demand is the result of consumption, investment, Government, and foreign spending. Consumption depends primarily upon the level of disposable (after income tax) income. The marginal tax take has taken a large bite from increases in income. From the first quarter of 1961 to the third quarter of 1962 personal income rose by $37.2 billion. At the same time Federal personal tax and nontax receipts, indirect business tax and nontax accruals; and social security taxes rose by $11 billion giving us a marginal tax rate of 29.6 percent. This is to be compared with an average rate of 18.3 percent and 17 percent for these two quarters. In 1948 the average rate was 15 percent, for 1962 it was 19.2 percent, and for 1963 (third quarter) it was 19.6 percent. The addition of the Federal corporate income tax to the tax drain and of corporate profits to personal income gives a marginal tax rate of 45 percent for the above period.

Over this same period total Government receipts increased by 39 percent of the increase in GNP (rather than personal income). (The average for 1962–63 was 28.7 percent.) The addition of undistributed corporate profits to this leakage gives a figure of 47 percent. Thus, after this drainage occurs, and after personal saving, each dollar increase in GNP will generate about 50 cents in additional consumer expenditure.[6] With a given level of Government expenditures such a large drainage in Government revenue must be offset by a very large increase in investment. Under conditions of excess capacity, however, this is too much to expect from private investment.

OTHER OBSERVATIONS ON THE FULL EMPLOYMENT SURPLUS-DEFICIT APPROACH

Certain comments should be made about the economic circumstances which are related to the full employment surplus: (1) This situation has developed at a time when there was not a vigorous underlying demand in the economy. Had we experienced such a vigorous underlying demand as after World War II the situation would not have been as serious. Up until about 1957 several factors helped maintain demand and/or offset the built-in surplus: the vigorous consumer and investment demand in the earlier postwar period, the Korean war expenditures and large deficits, the continued high rate of investment

[5] Richard Musgrave has, in effect, extended the analysis. See in particular his "On Measuring Fiscal Performance," the Review of Economics and Statistics, May 1964, pp. 213–220.

[6] The CEA estimates that for each extra dollar of GNP 30 cents goes to extra Federal receipts, 6 cents to State and local government revenues, and 10 cents to corporate retained earnings. Disposable income is then about 54 cents, of which about 93.5 percent is spent for consumption.

and residential construction, the automobile sales of 1955, the Suez crisis in 1956, and (sporadically) Government expenditures. (2) The tax rates existing up to 1964, except for some changes made in 1954, were designated to combat the inflationary pressures resulting from the military buildup during the Korean conflict. Personal, corporate, and other tax rates were raised at that time and remained high until 1964. The tax system was and to a considerable degree still is set up to combat a high demand, "high pressure" economy in which inflation is a serious threat.

(3) Had there not been attempts to balance the budget with 5 and 6 percent unemployed either taxes would have been reduced or expenditures increased. The only way in which the drag on the economy created by the tax structure could have been offset is by a reduction in tax rates, or by increasing the level of Government expenditures. As we noted previously, with current tax rates the built-in increase in revenues at the full employment level is some $6 billion. Obviously, expenditures have not been increased enough to offset the tax drain. This is even true for the years 1961 through 1964. Even though these years saw a significant improvement in fiscal policy (expenditures were up some $10, $7, and $7 billion in each of the first 3 years and taxes reduced some $8.5 billion in 1964), this has not been sufficient to substantially reduce the gap between potential and actual GNP.

(4) In addition, our income tax dips into the lower income ranges, and hits fairly hard the middle income group. By far the largest portion of revenue produced by the personal income tax comes from lower and middle income brackets rather than from the upper income groups. This is simply because there are not very many people in the upper income groups.

(5) Further, inflation has raised all of our money income since 1950, which has placed some of us in higher income tax brackets. The amount of tax actually paid then has increased, for some absolutely and for others in percent also. An offsetting factor, of course, is the rate of increase of one's dollar income.

(6) Also accounting for an increase in the annual tax take is the natural upgrading of and growth of the labor force. This means that we have an increase in the number of people paying taxes at higher rates and in inflated dollars, and also in the number working and paying high taxes again in inflated dollars.

(7) Finally, a relatively tight monetary policy prevailed during the upswings of the middle and late fifties.

The increasing acceptance of the full employment surplus theory has several implications. (1) This approach gives a better measure of the impact of fiscal policy. (2) It points out the need to reevaluate our attitudes toward expenditures. (3) It drives home the point that the tax rates required to yield a given surplus, or even a balanced Federal budget, at full employment provide no assurance that full employment will be reached. In fact, such tax rates may interfere with the attainment of a full employment level of GNP. As several economists have pointed out, we should not attempt to measure the expansionary effect of a given deficit, or the extent to which a given surplus or deficit at full employment deviates from a balanced budget at full employment, but rather we should compare the actual surplus with the surplus or deficit that is needed to attain full employment. (4) It has put in better perspective the inadequate saving-investment, structural-transformation, and other related and similar arguments pushed so strongly by the ardent investment advocates. (5) It reemphasizes the fact that total demand may drag behind total supply and hence retard growth.

V. ARRIVING AT AN EFFICIENT USE OF RESOURCES

Too often we have taken a muddle-headed approach to the issue of Government spending. Prof. Richard Musgrave has helped clarify our thinking on this problem with his approach to the Federal budget. That is, he divides the budget into three branches—the allocation, distribution, and stabilization branches. The allocation branch handles the problem of providing for social wants. It is the medium through which we determine the amount of resources that will be allocated for the satisfaction of social wants. The amount of social goods and services that will be provided will be paid for by taxes imposed for this purpose. It is necessary to impose taxes to release resources to satisfy these social wants because full employment is assumed. These wants should be satisfied regardless of the level of income and employment and therefore should not be varied countercyclically, generally speaking. Society must make a decision as to how its resources shall be used—that is, how much shall be used for public and how much for private purposes. Except for certain circumstances, the allocation budget is balanced even though the total budget may not be because of the need for a deficit or surplus in the stabilization branch. Taxes, as imposed by the allocation branch, are an index of opportunity cost. If people decide they want more public goods or services, they must be willing to pay for them.

The problem of income distribution is also dealt with separately. Society decides on the type of income distribution it desires and the distribution branch taxes and transfers income in order to secure this distribution. The distribution problem then is dealt with explicitly.

The third budget is handled by the stabilization branch. Its purpose is to maintain a high level of income and employment and a stable price level. Taxes are to be raised if demand is too high and transfers raised if demand is too low. The stabilization budget is either a surplus or deficit budget. It will be balanced only when both taxes and transfers are zero—when private and allocation branch expenditures are high enough to secure full employment without the aid of the stabilization branch. Since the satisfaction of social wants is the function of the allocation branch, the stabilization branch will not normally raise or lower public expenditures on goods and services. The taxes and transfers of the stabilization branch are to be proportional to the system of income distribution decided upon.

Professor Musgrave's three-pronged approach to budgeting has the great advantage of separating decisions on these problems. Professor Musgrave is among the first to recognize that Congress and the administration are unlikely to rush to adopt his proposal, but the critics of unbalanced budgets should be pleased because the scheme has fiscal discipline built into it. Under circumstances in which the stabilization and allocation functions are not separated and a deficit is required for stabilization purposes, taxes may no longer serve as an index of opportunity cost. The fact that a deficit is needed may lead the public to feel that more public goods or services can be had cost free. On the other hand, the requirement of a surplus can bring the attitude that public services are more expensive than they really are. Dissatisfaction with paying taxes for both stabilization and allocation purposes creates this attitude, the result of which might be the provision of inadequate public services. Professor Musgrave attempts to avoid both these distortions which prohibit taxation from properly pricing public services.[7] Contrary to the shibboleths of the unknowing or irresponsible politician, we can afford what we want to afford in the realm of public goods and services.

VI. ATTAINING GREATER STABILIZATION

As we noted previously it is not likely that the Musgrave budget will be adopted in the near future. An awareness of its unique approach, however, helps clarify thinking on these issues and simplifies the decisionmaking process to some extent at least. Two other actions may be taken by the Congress that would greatly strengthen our defense against both recessions and inflation. The first is the delegation to the President of discretionary authority to raise and lower taxes, and the second is the upgrading of the unemployment compensation system. Discretionary tax authority could be delegated to the President with the legislative controls that the Congress deems appropriate, as was proposed in 1962. Such discretionary authority has many advantages. It is effective; its impact is immediate; it is flexible; and it avoids lengthy congressional debates, hearings, and other delaying tactics.

But the discretionary tax cut idea is important in another respect. With the exception of the 1964 action, tax reductions to combat recessions have been extremely difficult to secure. For the most part those tax cuts made during postwar recessions were not undertaken for countercyclical purposes but rather were fortuitous. Resort was made then to increases in expenditures, but these increases in expenditures were not generally undertaken because of stabilization considerations. They were, in fact, primarily increases in defense spending. Hence increases in expenditures were not justified as contributing to growth and/or stabilization, but rather were rationalized as necessary for national defense purposes. As such they have coincided with the challenge created by the launching of sputnik, or such crises as Berlin and Cuba. What socially acceptable excuse will we have to increase expenditures during the next recession?

Granting to the President the discretionary authority to cut taxes will not only avoid what may turn out to be quite inefficient techniques of determining the allocation of resources between the public and private sectors, but will give him the authority to cut taxes that he may not be able to secure, through special legislation, for various political reasons, at the particular moment it is needed. It may also encourage a conservative President who would never request such authority to actually raise or lower taxes since he already has the au-

[7] See Richard A. Musgrave, "The Theory of Public Finance," New York: McGraw-Hill, 1959, pp. 6–26, 517–520, 522, and 558, and his "Principles of Budget Determination" in Subcommittee on Fiscal Policy, Joint Economic Committee, "Federal Expenditure Policy for Economic Growth and Stability," papers, Nov. 5, 1957, pp. 108–115.

thority. He may be pressured into taking countercyclical action. Finally, the provision of such authority avoids the delays and bitter arguments about whose taxes should be cut, etc., that characterized proposals to cut taxes in recent recessions.

Given prevailing attitudes toward debt, tax cuts, and expenditures, it would be wise for Congress to push for the acceptance of discretionary tax authority. Such authority should also include, of course, the power to raise tax rates for purposes of attaining price stability when needed. There seems to be no question that a limited delegation of tax authority would be constitutional, that it would constitute an important step forward toward the realization of the goals of the Employment Act, and that many of the Congress's fears of the proposal can be adequately dealt with.

A second important proposal that may be acceptable is the improvement of the unemployment compensation system. The unemployment compensation system is a very important element in our antirecession toolbox. It is difficult to exaggerate its importance. It is furthermore an existing tool and its orthodoxy should contribute to greater acceptance of suggestions for improvement. Since the program has been evaluated elsewhere [8] it will suffice to note here that its coverage should be expanded, payments should be raised, and it should be made financially solvent (which it is not in many States).

VII. OTHER ISSUES IN FISCAL POLICY

Many other proposals for making fiscal policy more effective could be discussed in detail. Since space is limited we shall only mention some of them here.[9] Further improvements can be made in the presentation and uses made of the Federal budget. Greater use of the national income product and account data have already been referred to. A national economic budget that considers potential output and the level of output likely to be achieved without compensating Federal action, and which covers a period of more than 1 year, could be adopted. Congress could reorganize its committees so that a view of total budget expenditures and receipts is secured. In its Economic Report the CEA should continue to use explicit, quantitative, potential, and likely employment levels, and spell out specific actions to raise the actual levels or contain inflation. It should also continue to spell out what is needed and expected from monetary policy. There is also a need to secure effective coordination of the various programs and agencies of the Federal Government that are part of or related to fiscal policy, between the Federal and State and local governments, and finally between monetary and fiscal policy. Monetary and fiscal policy can, of course, offset each other, or one may partially frustrate the other. There can be significant costs (financial and employment costs) to society if the two are not coordinated. This may call for reform of the Federal Reserve System. In recent years there have been too many questions raised about the policies and operation of the system, and very serious accusations of a great ignorance of modern economic theory on the part of its spokesmen, to ignore the problem.

[8] See the discussion and references in Keiser, op. cit., pp. 468–470.
[9] For detailed discussions see ibid., ch. 20.

VIII. SUGGESTIONS FOR FURTHER RESEARCH AND CONSIDERATION

There is always a need for improvement in our analyses. We note, for instance, that a given surplus or deficit may be either expansionary or contractionary depending upon who pays the taxes and to whom the expenditures are made. In a similar manner various expenditures have varying impacts on employment. From the first quarter of 1961 to the fourth quarter of 1962, for example, the marginal GNP per job was $33,600, but during the second year of recovery (1962) the marginal figure dropped to $13,200. The average GNP per job was $7,800. The average figure used by the CEA in early 1963 was $15,500. Varying relationships such as these must be accounted for in appraising the impact of fiscal policy, especially its impact on employment. A given level of expenditures on hard goods creates more jobs than the same expenditures on missiles.

In a similar manner there is a need for greater and continuing research on such matters as potential output, capacity indexes, the makeup of the labor force, the skills required for unfilled positions, and other such matters on which it is important to have accurate information in order to arrive at rational policy decisions. Of further significance is the problem of disarmament. It would be helpful if the Joint Economic Committee were to bring together the various materials and studies that have been done in this area, survey the adequacy of the research that has already been done and support additional research where it is needed, and drive home to the Congress the action that is necessary when the time arrives.

Finally, if an enlightened fiscal policy is realized it is highly likely that attention will have to be given to inflation. If the problem has its origins in the consumer sector tax increases and consumer credit controls over automobiles, other durables, and homes may be imposed. Once again, however, many groups will resist this and it would be extremely helpful if the President were to be granted discretionary tax authority. It would seem advisable to give the Federal Reserve standby authority to impose credit controls when the administration or Congress deems it necessary. (This statement is made in full recognition of the fact that spokesmen for the Federal Reserve have stated that they do not want such authority.)

An important source of inflationary pressure may be investment, as it has been in certain past periods (e.g., 1955–57). Short of outright rationing, licensing, and price controls, devices for restraining inflation originating in the investment sector have had questionable success. The usual prescription for restraining inflation is high rates of interest and restrictions on the availability of credit. Sufficient analysis has been done to cast considerable doubt on the effectiveness of monetary policy and the length of time required for its impact to be felt. Further consideration should be given to the selective devices that have been proposed and others that have been used in Europe. These devices should, of course, also be considered for the expansionary purposes that they may serve. A desirable feature of any antirecession or anti-inflation policy is that it be thoroughly countercyclical—that it be completely reversible. (The 1962 tax credit and the 1954 and 1962 depreciation changes do not have this feature.) In considering these devices, however, we should very carefully consider the equity issue. Special tax concessions on investment expenditure can be wasteful, inequitable, and can create undesirable wealth and income distribution effects, as Professor Musgrave has noted.

The final topic on which we shall comment briefly is tax reform. There is wide agreement among economists that tax reform is desirable, and a great deal has been written about the subject in the last half decade. Tax reform is extremely difficult to attain, however, as the Kennedy administration found out. President Kennedy had hoped to make the tax reform the price of the tax cut, but was unsuccessful. Tax reform and tax reduction were two separate issues and probably should have been dealt with separately. At any rate, there is an urgent need to correct the gross inequities that exist: the many loopholes that exist should be plugged and the degree of progression in the statutory rates reduced, and large amounts of income that now go tax free should be brought into the tax base.

STATEMENT BY MICHAEL E. LEVY,[1] SENIOR ECONOMIST, THE NATIONAL INDUSTRIAL CONFERENCE BOARD, NEW YORK, N.Y.

In my memorandum I shall comment exclusively on two major fiscal issues that are of great current interest and are likely to increase in importance over future years: (1) the past contribution of fiscal policy to economic stability and growth, and means for improving this performance; (2) the relation of Federal fiscal policy to State and local government finances.[2] There exist many other fiscal issues that may well deserve the attention of the subcommittee, such as: (3) desirable revisions of the tax structure; the nature and future of (4) Federal housing and urban renewal programs (5) Federal "antipoverty" programs, and (6) Federal manpower training and retraining programs. The fact that these latter issues are not discussed in my memorandum does not necessarily imply that they are of lesser importance, but rather that I do not consider myself particularly well qualified to comment on them at present.

1. FISCAL POLICY FOR STABILITY AND GROWTH

During the major part of the 1950's, following the Treasury-Federal Reserve accord of March 1951, monetary policy was the leading tool for economic stabilization, while fiscal policy fell into relative neglect. At the end of that decade, however, and at the outset of the present one, a change in the economic environment resulted in the reemergence of fiscal policy as a dominant tool for economic stabilization and growth. The serious and persistent U.S. balance-of-payments difficulties and gold losses since 1958, the relatively high average unemployment rate during recent economic expansions, and a presumed slowdown of economic growth, were among the leading new environmental factors that induced this reemeregence of fiscal policy.

The balance-of-payments problem, by exerting a certain constraint on the use of monetary policy for purely domestic purposes, implicitly stressed the need for greater reliance on fiscal measures. The relatively high average level of unemployment and underutilized capacity during recent economic expansions and the widespread belief that the rate of growth of the U.S. economy had slowed down, gave rise to the new stagnation thesis which centered on fiscal considerations. A major contention of this thesis was that excessively high full employment budget surpluses, built into the structure of the postwar Federal budgets, had exerted a drag on the U.S. economy and contributed to a

[1] The statements in this memorandum are based on the author's evaluation of some current fiscal issues; they need not necessarily reflect the position of the Conference Board.

[2] These two sets of issues have been selected for comments not merely because of their intrinsic importance, but also because of my relative familiarity with them, based on my recent research in these areas.

slowdown in economic growth and to high unemployment.[3] Recent fiscal measures, such as the liberalization of the depreciation guidelines, the investment tax credit, and the 1964–65 tax cut, flowed largely from this stagnation analysis.

By the end of 1963, the basic proposition of the new fiscal analysis—that the U.S. economy had suffered from unusually sluggish growth during the last several years—had been seriously questioned by new economic research.[4] Since then, expansionary fiscal measures have been advocated not so much as a prescription against sluggish U.S. growth, but rather as a means for reducing unemployment and increasing the overall level of resource utilization.[5] Thus 1963–64 marked a definite change in the conceptual underpinnings for the expansionary fiscal policies of recent years.

Yet a group of prominent economists has gone even further in arguing that both the inadequate economic performance during the end of the last decade and the impressive recent recovery were associated mainly with monetary, rather than with fiscal, developments. According to this group, the initial villain, as well as the subsequent hero, was not so much fiscal policy, restrictive during the earlier period and expansionary during the last several years, but rather the rate of growth of the money supply which was said to have been inadequate during the second half of the 1950's and exceedingly (if not excessively) rapid in the most recent past.[6]

This extensive controversy concerning the causes of the recent fluctuations in U.S. economic performance points up the need for a thorough reevaluation. Such a reevaluation should include an analysis and assessment of the operation and economic impact of fiscal, as compared with monetary, policy. It should focus particularly on the recent past, with special emphasis on the effects and effectiveness of the 1964–65 tax reduction, as well as of the prolonged policy of monetary ease during the current economic expansion. The analysis should utilize both the new tools of fiscal analysis, such as the full employment surplus and the GNP gap, which have been developed and refined during the last several years, and the new theoretical and empirical contributions of monetary analysis associated mainly with the new quantity theory approach.

Moreover, the new tools for fiscal analysis should be further sharpened and refined, so as to improve our ability to use fiscal policy

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[3] For a critical review of this thesis and of the proposed remedies, see Michael E. Levy, "Fiscal Policy, Cycles and Growth," National Industrial Conference Board, New York: 1963.

[4] Eg., Clayton Gehman, "Economic Growth Trends and Measurements," and Michael E. Levy, "U.S. Growth Rates: The Kink in the Curve," two addresses at the annual meeting of the American Statistical Association, Cleveland, Ohio, Sept. 5, 1963, published in the 1963 Proceedings of the Business and Economic Statistics Section of the American Statistical Association. (An edited version of the latter address was reprinted in the November 1963 issue of the Conference Board Business Management Record. The Gehman address was based on material contained in a previous article: "Measuring and Analyzing Economic Growth," Federal Reserve Bulletin, August 1963.)

[5] In this respect, the 1964 Economic Report of the President marks a departure from previous reports which stressed not only underutilization of economic resources, but also sluggish growth.

[6] The basic framework for this type of analysis is provided by the new quantity theory, associated mainly (but not exclusively) with Milton Friedman and his disciples at the University of Chicago.

Recent applications of this analysis to the U.S. economy, and major conclusions derived with regard to the economic performance since the late 1950's, are contained in testimony by Milton Friedman, Allan Meltzer, and Karl Brunner at the hearings before the House Committee on Banking and Currency, Subcommittee on Domestic Finance, "The Federal Reserve System After 50 Years," vol. 2 (1964).

effectively. These improvements should include a special budget analysis that would divide total (actual and projected) budget receipts and expenditures into built-in receipts and expenditures on the one hand, and discretionary receipts and expenditures on the other. Such data should be provided for the actual (or projected) level of GNP, as well as for full employment GNP. The full employment estimates would include data on the full employment budget surplus which has been a cornerstone of the new fiscal analysis.

Clearly the development of such estimates faces considerable conceptual and statistical problems, but the importance of such information for economic analysis and for an effective fiscal policy is so great that a considerable effort along these lines would appear to be highly desirable. Such efforts should be supplemented by projected budget estimates that cover several future years.

The full employment budget surplus has become a cornerstone of the new fiscal analysis in the United States. Yet implicit in this type of analysis is some measure of a private full employment deficit, i.e., an excess of full employment investment over full employment saving within the private sector of the economy. The lack of adequate estimates of private full employment saving and investment is a major gap in our knowledge.[7] Now that the full employment budget surplus has come to be accepted as an important tool of the new fiscal analysis, estimates of private full employment saving and investment should be viewed as intrinsic components in this tool chest, and therefore deserve a high priority in the near future.

2. FEDERAL-STATE-LOCAL FISCAL RELATIONS

Most economists seem to agree, at present, that the revenue structure of the Federal budget has a relatively high long-term income elasticity that would tend to raise the full employment budget surplus to excessively restrictive levels in the course of several years of rapid economic growth, unless this tendency was offset by a combination of increased expenditures and/or tax reductions. Yet there is widespread disagreement among economists with regard to the relative merit of alternative combinations of expenditure increases and/or tax reductions that would keep the full employment surplus at an appropriate level. The implications of these alternatives should be explored more thoroughly.

In this connection, some economists have pointed to the growing revenue needs at the State and local level. Many State and local governments have encountered increasing difficulties in finding new revenue sources to provide funds for their large and rising expenditures.[8] Increased Federal transfer payments to State and local governments have been advocated by some experts as a partial solution to this problem. The pros and cons of such proposals should be reviewed within the broader framework of overall trends and developments of intergovernmental fiscal relations in the United States.

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[7] For a limited recent attempt to estimate full employment saving and investment in the private sector, see Levy, op. cit., ch. 3.

[8] These increases in State and local spending have been associated mainly with population growth, increased urbanization, and the demands for better education and other services linked to rising per capita income.

Statement by Roland N. McKean, Professor of Economics, University of California at Los Angeles, Los Angeles, Calif.

My suggestions are general ones pertaining to the long run rather than specific steps that might be taken immediately.

There are so many reasons for expanding Federal outlays that I am concerned about them becoming too large, and so many reasons for centralizing expenditure decisions in the Federal Government that I am concerned about overcentralization. Finally, it is so important to keep employment opportunities growing that full employment will surely continue to be a major longrun issue.

I. OVEREXPANSION OF FEDERAL EXPENDITURES

A. Forces tending to expand Federal outlays

There are many programs that may cry out for expansion, especially as the difficulties associated with urbanization and racial conflict become more severe. For example, to ease these difficulties, it may be desirable to expand special kinds of education and training, research, health services, and recreation programs. In many ways it would be better if these activities were left to local authorities, but because of the factors noted below, they are likely to involve the Federal Government.

A major reason for this is growing awareness of the spillover effects of one locality's action on the costs or gains of other private and Government units. For years economists have been concerned about spillovers in the private sector; e.g., the impact of airline operations on the noise level and the costs of other firms and households. The same phenomenon exists in the public sector. What one community does about racial integration, education, or sewage disposal affects costs and gains in other communities. Such activities may need better coordination than is provided by ordinary bargaining among governmental units, and Federal subsidies, grants, and programs are likely to play an expanding role. Equity considerations also push us in this direction. The simplest way to transfer resources from wealthier States and communities to the poorer ones is to have the Federal Government do the taxing and spending.

Another reason for expecting Federal expenditures to rise rather steadily is the nature of the bargaining mechanism, which might be called the unseen hand in Government. Like the price mechanism in the private sector, the bargaining mechanism causes officials to take into account many costs inflicted on others and benefits bestowed on others. But it works very imperfectly, and often officials and voters are not made to feel the full costs or gains generated by their actions. With respect to particular programs, the benefits per recipient are large and may be perceived more keenly than the relatively small costs per taxpayer. I would expect this to generate forces yielding a gradually rising budget.

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B. Disadvantages of very large Federal expenditures

I am not alarmed because the debt may grow. In my view there is definitely a fate worse than debt. In fact there are many such fates, for debt growth in our system is essentially growth of the stock of money and near money, and those stocks ought to grow. But large Government expenditures pose other hazards. Ultimately they could lead to the neglect of alternatives, because programs would cater to broad majorities more than to minority or local needs, and indeed the incentives of lower level units to propose alternatives might diminish. The result could be to inhibit change, flexibility, and growth. Also, heavy Federal taxes and expenditures could ultimately make too many persons beholden to too few, actually reducing the number of options open to individuals, and impairing their willingness to speak and vote freely. (The main reason that one writes what he pleases is because he has numerous job options.) So far, of course, government activity in Western nations has surely increased the options open to most individuals, but beyond some point it could work the other way. Like growing older, it would happen so gradually that it would be hard to become alarmed at any particular moment. Yet, like growing older, it could ultimately be fatal.

II. LACK OF EMPLOYMENT OPPORTUNITIES

Maintaining employment opportunities is an extremely important part of the solution to the problems of urbanization, racial conflict, a restless younger generation, technological change, and, indeed, the preservation of options and a high degree of freedom. I would like to see opportunities maintained, however, without excessive Federal outlays. For that reason, I welcome the use of tax cuts, which avoid ratcheting Government outlays up (and might even ratchet them down on some occasions). I also think it is important for fiscal policy to be managed so as to allow the money stock to grow, for it plays a vital role in maintaining prosperity. For managing fiscal policy, the cash budget seems to be the most useful budgetary format. With outlays determined according to their merits, I would like to see taxes adjusted to influence disposable income and the stock of liquidity.

III. OVERCENTRALIZATION OF EXPENDITURE DECISIONS IN THE FEDERAL GOVERNMENT

Another issue that I believe will be of growing significance is the centralization of decisionmaking about expenditures within the Federal Government. As the scale of activity increases, congressional review, decentralization within departments, and various checks and balances are harder to maintain, and there are several forces that may be conducive to centralization.

Forces tending to centralize decisionmaking

Again, a growing awareness of spillovers propels us toward centralization. In defense, choices about strategic forces affect the costs and payoffs from decisions regarding limited war forces. In natural resource programs, dams in Colorado affect the quality of water downstream, the agricultural price-support program, and so on. Such interrelated choices may be better coordinated by having higher authorities make decisions, and to some extent this should be done.

Some of our analytical tools may also be conducive to centralization unless they are used carefully. If 5-year program budgets are adopted in the departments, for example, they may become used as a control device rather than as an information system. That is, if longer term planning decisions are recorded in an official program budget, it may seem more important to make sure that lower levels adhere to the plan; that is, that they are controlled more effectively. Also, cost-benefit analysis, which can be moderately helpful if used with caution, may lend a spurious certainty to estimates and encourage centralization to enforce the "correct" decisions. (One of the important reasons for dispersing authority is to hedge against uncertainties.)

Yet centralization of authority within Federal departments brings disadvantages, which must be weighed against its advantages. It may lead to the neglect of alternatives, the loss of incentives at lower levels to propose tradeoffs and alternatives, and the neglect of very real uncertainties. It can help produce Cook's tour planning while what we usually need is Lewis and Clark planning—planning for flexibility.

Because of these various considerations, I think we should keep trying (1) to err in the direction of leaving too much rather than too little in the hands of State and local authorities; (2) to use tax rather than expenditure adjustments to influence employment and growth; and (3) to develop institutions and methods to further long-range planning, not for highly specific tasks, but mainly for flexibility.

Statement by Gordon W. McKinley, Vice President, Economics, McGraw-Hill, Inc., New York, N.Y.

Current trends in Federal fiscal policy evidence a heartening growth in understanding of the relationship between Government finance and the effective working of our free enterprise economy. The present leveling in Federal Government expenditures coupled with last year's reduction in income tax rates constitute sound and imaginative use of fiscal policy to provide the setting most conducive to rapid economic growth, while at the same time accomplishing reforms which were long overdue.

The leveling in Federal expenditures is itself a desirable development. It is not necessary to pass judgment on the optimum division between private and public spending to draw the conclusion that the great swelling in Federal Government expenditures during the postwar period must inevitably have brought inefficiencies and wastes as well as some unintended yet nevertheless harmful effects. The extent of inefficiency and waste in the Federal establishment is sometimes exaggerated, but it would be remarkable if any organization which has grown as rapidly as the Federal Government and which has so seldom been confronted with the necessity to reduce expenditures should not have drifted into practices and policies which are careless, inefficient, and misdirected. Business enterprises which are protected from competition and which by good fortune remain in favor with their customers for extended periods of time certainly become prone to waste and inefficiency and the same factors encourage these faults in Government. There are few forces quite so effective in promoting efficiency and self-examination as a reduction in spending money, so that for this reason alone it is desirable that there should be periodic reductions in Government expenditure.

If the current tighter hand on Government expenditures is maintained and intensified, the effect is likely to be that more, not less, of our people will be served and aided by Government, that respect for Government will grow, and that incidentally the morale of Government employees will improve as they come to take pride in the effectiveness of the organization with which they are associated.

The second aspect of current Federal fiscal policy which augurs well for the future is the attention being given to tax reduction and reform. The recent cut in personal and corporate income taxes, at a time when business activity was high and the Federal budget was not yet in balance, required courage and imagination. It is a departure from past theories and practices and is a particularly important experiment because it depends for its success not on Government but on the vitality of the private sector of the economy. It is based on the proposition that private spending, freed of the burden of excessive taxation, can prove a more dynamic force than Government spending in driving the economy to its full potential.

The ultimate effects of this experiment have still to be felt but in its initial impact the tax cut must be judged an unqualified success. In the first quarter of 1964 consumers anticipated the reduction in taxes through a $9 billion jump in the rate of their expenditures. Thereafter, in the second and third quarters, they added an additional $14.5 billion on top of the already high opening quarter volume. The rate of consumer expenditures thus rose in the first 9 months of 1964 by $23.5 billion, a greater absolute increase in 9 months than had occurred in any full year during the past decade, and a greater percentage increase than in any other 9-month period since the outbreak of the Korean war. The relationship between the growth in business capital expenditures and the tax cut is not so statistically obvious, but it is just as real. There is no question that the confidence engendered by the tax cut was a crucial factor in the $6 billion rise in capital spending during 1964.

Equally important, the tax cut has not set off an unbridled boom. Prices have been relatively stable, wage increases in most cases have been within the bounds of productivity improvements, inventories are unusually low relative to sales, and there is a notable absence of a speculative atmosphere. The tax cut is not the answer to all of our economic problems. For instance, there is danger that the forthcoming steel labor negotiations will once again set the stage for a recession. But the tax cut has shown that the economy will respond promptly and in a noninflationary fashion to a lessening in the tax burden.

Fear has been expressed by some economists that, because Government income and outgo will again approach balance in the last half of 1965, the economy may turn downward for want of a sufficiently stimulative fiscal policy. A recession could begin in the last half of 1965 but if one does it will not be because Federal income and outgo happen to come into balance at that time. Federal fiscal policy at present is expansive because Government expenditures are exceeding revenues by a seasonally adjusted annual rate of something like $4 billion. But the direction of movement of fiscal policy is toward restriction because Government expenditures are running fairly level whereas Government revenues are climbing quite rapidly. Fiscal policy will thus become steadily more and more restrictive (or less and less expansive) during the rest of 1964 and through 1965. But this process is occurring, and will occur, in a smooth, steady fashion. It is a complete misconception of the impact of fiscal policy to suppose, as some economists appear to, that at the moment when Government revenue first equals Government expenditure sometime in late 1965 the effect of Government finance will suddenly shift from stimulation to restriction.

The idea that a recession is likely late in 1965 thus must be based not on any change in the Government's position at that time but rather on an assumed change in the private sector of the economy. I have not yet heard any really convincing argument (other than the possibility of a severe steel inventory cycle) which would lead to the conclusion that the private economy is likely to run out of steam in the last half of 1965. My guess is that the private sector will continue all through 1965 to be willing to go into debt more rapidly than the Government moves out of a deficit position, with the result that total expenditures and total output will expand throughout the year.

All of the above does not deny the fact that there may come a time during the next few years when a Federal budget surplus could outweigh the proclivity of the private economy to go into debt and fiscal policy could thus contribute to a recession. My previous discussion was intended simply to point out that this possibility has no necessary relation to the time in 1965 or any other year when the budget first reaches a balanced or a surplus position. The possibility of a fiscally induced recession does not depend upon the absolute position of the Federal budget but rather upon the relation between what is happening to Government finance and private finance. It is, in other words, a matter of balance.

Economists have long noted the advisability of maintaining a rough balance between private and Government fiscal policy over the business cycle. They have also been concerned with secular balance. Keynes early pointed out that there are equilibrium situations possible for the economy other than the full employment situation; Hansen worried about long-term stagnation. What is new about the current fiscal policy approach is not that it has suddenly discovered the need for secular balance but that it has recognized that the balance can be achieved through variations in taxes quite as well and perhaps better than through variations in Government spending. Economists have recognized the truth which businessmen over the years have described somewhat vaguely when they complained of the burden of excessive taxation.

No one knows exactly what the average Government surplus or deficit over a period of years should be in order to provide that balance to private fiscal policy which will permit full utilization of our resources without provoking inflation. What we are coming to realize is that the first task must be to encourage the private economy to reach full employment before searching for this secular balance. It is quite possible that at full employment (with the confidence and optimism which that situation would engender) it would be advisable for the Federal Government to average a budget surplus over a period of years whereas at less than full employment the result might be, in fact has been, an average deficit.

It therefore seems to me that in the years ahead Federal expenditures should be held as closely as possible to their present level and taxes should be reduced in a series of steps as found necessary to encourage the private economy to full output. This is the path most likely to encourage a vigorous economy, to expand the sphere of private initiative, and in the end to achieve a sound Government financial position.

Statement by Lloyd A. Metzler, Professor of Economics, the University of Chicago, Chicago, Ill.

As I see it, the principal problem before us is to follow a fiscal policy which will permit us a reasonable degree of growth without unduly complicating our balance of payments position. In some respects there are problems in an affluent society which cannot be solved by fiscal policy at all. I refer, in particular, to the areas of unemployment and poverty which have occurred in such States as West Virginia and the Appalachian region. The retraining program which we currently are undertaking seems to me the appropriate program for this type of unemployment. On the other hand, there is no point in retraining an unemployed person unless there are jobs for him to do with the training he has received. For this reason, fiscal policy would appear to be a sort of backdoor method of assisting the retraining program but not a primary goal in itself.

Finally, I should like to say a few words concerning the international complications which may arise if these fiscal policies are followed. As you know, we have consistently experienced a lower rate of growth and productivity than our Western European trading partners. The consequence is that when we do anything to expand the demand for goods and services we are immediately faced with a deficit in the balance of payments. It seems to me that a solution to this problem is the establishment of different rates than those prevailing under the International Monetary Fund arrangements. I am not prepared to say exactly how this could be done and I am well aware that devaluation will be difficult in any event because of the growth of our foreign short-term liabilities abroad. But I do not share the optimistic views of those who believe that the problem will cure itself if we just let it go long enough. I am of the opinion that the exchange rate should be adjusted to the balance of payments. Moreover, I want to point out that the longer we let this problem go the more difficult it becomes. In the decade of the fifties, for example, our foreign short-term balances abroad increased from something less than $10 billion to something more than $20 billion. Even if this growth did not continue indefinitely it would still be desirable to have a monetary system which would free our fiscal policies from restraints on our balance of payments. The Articles of Agreement of the International Monetary Fund provided no means by which balanced exchange rates could be established. And once the member countries entered the Fund these more or less irrational exchange rates were stabilized at a fixed rate. In my judgment what is needed to eliminate some of these irrational rates is a period of time during which exchange rates are allowed to fluctuate more or less freely. I do not venture to suggest whether a full employment policy would require a deficit in our Federal budget, but I am not inclined to think that it would.

At any rate, as long as Federal expenditures on defense are as high as $50 billion, private investment is likely to be high enough to give us full employment without a budgetary deficit.

Statement by Richard A. Musgrave, Professor of Economics and Public Affairs, Princeton University, Princeton, N.J.

In response to the subcommittee's inquiry let me suggest the following fiscal policy issues as those most likely to concern the Congress during the next decade.

1. To begin with, there are a number of issues relating to the role of the Federal Government in a changing pattern of fiscal federalism. These include the following:

(*a*) As the fiscal need to capacity ratio at the Federal level falls, while the same ratio at the State-local level rises, what techniques are there to reallocate tax resources? The tax sharing plan now under discussion points in this direction.

(*b*) What rational basis (or lack thereof) is there for the present distribution of fiscal responsibility for particular expenditure functions among various units (levels) of government? What basis is there (e.g., regional versus national impact of expenditure benefits) for rearranging this pattern?

(*c*) To what extent is the ability of lower level governments to deal with fiscal issues impaired by a lack of matching between existing borders of fiscal responsibility (i.e., States, cities) with the regions describing common expenditure needs and fiscal resources (e.g., metropolitan areas and regions cutting across States)? What can be the role of the Federal Government in remedying this situation?

(*d*) What is the fiscal responsibility of the Federal Government in dealing with unequal rates of development in various regions, arising in the course of national economic growth?

2. Another group of problems is related to the role of the fiscal sector in a growing economy. The following issues may be noted:

(*a*) Suppose that for various reasons the ratio of Federal taxes to GNP were to decline in future years. In tying the corresponding tax reductions to structural tax reform, one needs to know not only the defects of the tax structure at prevailing levels of average rates, but also whether the image of the "good tax structure" itself should be changed as the general level of rates is reduced. In the past, the growth of the Federal tax to GNP ratio involved (1) more reliance on income tax, (2) more reliance on lower middle-income taxpayers within the income tax. Is there any reason to reverse these trends?

(*b*) What is the role of public expenditures in economic growth? What institutional political changes could be made to render public expenditure levels more responsive to consumer and investor needs?

3. A third group of problems here noted do not follow a particular theme but are of new or continued importance. These include:

(*a*) The relation of tax policy to foreign trade and balance-of-payment issues.

(*b*) A review of social security finance. Given the matured and broadened social security system, does the original idea of contribution and reserve finance still make sense? Would it be desirable to replace payroll taxes by a value added tax?

(*c*) Notwithstanding the striking success of the tax cut, we are far from having developed an efficient mechanism for flexible fiscal policy adjustments. What techniques are there which will permit prompt action by a suitable body, while maintaining basic responsibility for tax legislation with the Ways and Means and Senate Finance Committees? This is a vital problem which might be investigated profitably by the Joint Economic Committee.

(*d*) The problem of efficient expenditure planning and legislating will continue to be with us, including longer term legislative action on capital programs, revision of decentralized appropriation procedures, relation of expenditure to tax legislation, and so forth.

STATEMENT BY JOSEPH A. PECHMAN, DIRECTOR OF ECONOMIC STUDIES, THE BROOKINGS INSTITUTION, WASHINGTON, D.C.

I am happy to respond to the request for my views regarding the important fiscal policy issues that are likely to face the Congress and the Nation in the coming decade. It is extremely important to take stock on these matters of public policy every few years. The Fiscal Policy Subcommittee of the Joint Economic Committee is performing a very useful public service in making this survey.

I believe that the major fiscal policy issues are: (1) How should the annual increase in Federal receipts be allocated to promote economic growth and stability? (2) What are the fiscal requirements of the State and local governments and how can the Federal Government assist them in meeting these requirements? (3) Can effective methods be devised to permit the Congress to act quickly on taxes and expenditures in the event of an economic slowdown or recession? (4) What was the economic impact of the precedent-shattering tax cut enacted under the Revenue Act of 1964? (5) What should be the next steps in Federal tax reform?

FISCAL POLICY FOR GROWTH

Assuming a modest rate of growth of 3½ percent per year and no change in tax rates, Federal revenues will rise approximately $6 billion per year in the next few years. Moreover, defense expenditures seem to be on their way down. This means that at least $6 billion, and probably more, will be available each year for expenditure increases, tax reduction, or debt retirement.

As the past few years have demonstrated, the U.S. economy will not grow at an adequate rate unless we are able to counteract the restraining effect of the Federal revenue system. Most of the European countries and Japan that have experienced high growth rates have recognized this problem and have taken action to prevent it from shackling their economies. Our trouble has been, first, that we have not recognized the problem until very recently; and, second, that we have not achieved a national consensus on methods of solving the problem.

It is important to note that high employment can be achieved by increased expenditures alone or by tax reduction alone. I would venture to guess that we will not confine our policies to one or the other extreme, but will probably use a mixture of both expenditure increases and tax reductions to achieve our objectives. But this is the most difficult policy to implement, because it is difficult to devise a specific rule or formula that should apply every year. The most important service the Fiscal Policy Subcommittee could do would be to educate the Congress and the public on the need to do something about this problem and to help in the formation of a national consensus.

FISCAL ASSISTANCE TO THE STATES AND LOCAL GOVERNMENTS

It is now commonplace to point out that the fiscal requirements of the States and local governments are large and growing, and that their revenue systems are inadequate to cope with these needs. Yet the Federal Government has done very little about this problem directly. Although it is true that Federal grants have risen substantially in the past decade, a substantial proportion of the increase is accounted for by highway expenditures. The public services for which the States and localities are primarily responsible in our Federal system of government—education, health, and welfare—are dependent for support on taxes that do not respond adequately to economic growth and are probably inequitable besides.

In light of the fact that the Federal revenue system is more than adequate to take care of the needs of the Federal Government, it is time to explore possibilities for funneling some of these excess revenues to the States and local governments. This will require an evaluation of the present Federal grant system to see how effectively it is operating to promote the Nation's needs. In addition, the subcommittee would be most helpful to economists working on this problem if it were able to achieve a consensus among Congressmen on the major ingredients of a formula that they would regard as practical.

STANDBY TAX AND EXPENDITURE LEGISLATION

Our success in avoiding a business downturn in almost 4 years should not lull us into a false sense of security regarding the business cycle. I know of no economists who believe that our defenses against recession are adequate. More important, now that we have experienced a long period of expansion, we should try to detect periods of slow growth and to devise methods of pushing the economy ahead even if an actual downturn has not occurred.

In 1962, President Kennedy urged the enactment of a "three-part program for sustained prosperity." His program included (1) standby power—subject to congressional veto—for temporary income tax reductions; (2) standby authority for public capital improvements; and (3) strengthening the unemployment compensation system. This program was shelved by the Congress largely because it felt that granting standby powers for such important matters to the Executive would be preempting congressional responsibilities.

I do not believe that President Kennedy intended to assume congressional prerogatives in making these suggestions. Nevertheless, in view of the cool reception accorded to these proposals, an effort should be made to devise new techniques that will be satisfactory to the Congress.

ECONOMIC IMPACT OF THE 1964 TAX CUT

Although economic activity has grown at a rapid rate since the enactment of the 1964 tax cut, opinions about its effectiveness vary greatly. Since this is the most important single fiscal action ever taken in the history of the United States, we should make every effort to evaluate its impact on as scientific a basis as possible.

Studies are already underway at the universities and private research organizations, but these will not be completed for some time. I would suggest that congressional study of the impact of the tax cut be delayed until late 1965 or early 1966 when these studies will have been completed.

TAX REFORM

The Revenue Act of 1964 contained a number of useful reforms of the individual income tax, but it fell far short of the recommendations made by President Kennedy and of the proposals discussed by experts on a number of occasions before the Joint Economic Committee and the House Ways and Means Committee. It is now clear that next year will be devoted to excise tax reform and reduction—a matter that should have immediate priority. The Ways and Means Committee has held extensive hearings on excise taxation this year, and there would be little point in repeating them next year. However, it is not too early to begin thinking about the next steps in tax reform once action on the excise taxes has been completed.

I would suggest that consideration be given first to the structure of the estate and gift taxes. These taxes account for only 2 percent of Federal revenues, but they are much more important than their revenue yield suggests. The objectives of the Congress in levying these taxes are by no means clear, and this confusion is reflected in a structure that makes very little sense from an equity or economic standpoint. A number of studies on the estate and gift taxes are now underway outside the Government as well as in the Treasury, and it will be well to defer hearings in this area until these studies have been completed.

Individual income tax reform is still in order, since the Revenue Act of 1964 left a number of very important questions unsettled. These include the tax treatment of single persons and married couples, the personal deductions, capital gains, and other exclusions from taxable income. These are perhaps the most difficult and complex issues in the tax field, and it is important that they should not be neglected.

STATEMENT BY RAYMOND J. SAULNIER, PROFESSOR OF ECONOMICS, BARNARD COLLEGE, COLUMBIA UNIVERSITY, NEW YORK, N.Y.

I. THE ECONOMIC SITUATION AND OUTLOOK

First, it is important to the kind of policy judgments we make for 1965 to note that our economy is operating today not only at very high levels but close to the practical upper limits of capacity. A good measure of the economy's pitch or pulse is the average length of the manufacturing workweek, which in November stood at 40.9 hours. This is as high as it has been since 1959 and as high as the level reached during a few months in 1955–56 when our economy was under genuinely excessive pressures. Another measure of pressure in the economy is the fact that the index of prices of industrial materials is as high today as it has been at any time since the Korean war period, that it reached its present level by a rise that has been both abrupt and rapid, and that price increases are continuing and multiplying. As to the extent of utilization of economic resources, unemployment among married men has been under 3 percent for most of 1964, which is almost as low as it was in the 1955–56 period; and it appears that productive capacity in the machinery-producing industries is being used to the extent of 85 percent or more, again very nearly at the level reached in 1955–56. As a general description, I would not say that our economy is overheated; but we are very close to that point. This is a judgment matter, but I would say we are as close to overheating as it is safe to get.

Second, it is often said that the balance of our economy is good; in a sense this is true but we must not overlook the fact that the economy's advance in the past few years has been achieved by keeping it under continuously heavy pressure and that this pressure raises questions about balance. Because I doubt that the extent of the pressure is fully realized, let me describe it briefly.

(1) For the past 4 years, Federal expenditures have been increasing by about $6 billion a year, faster than the growth of the economy.

(2) We have had three major tax liberalizing moves, the most recent of which involved a revenue loss in the neighborhood of $13 billion, concentrated largely in the calendar year 1964.

(3) The Federal budget has been continuously in deficit, with the deficiency in the fiscal years 1961–64 amounting to $17 billion on a consolidated cash statement basis and to nearly $25 billion on an administrative budget basis.

(4) The use of private credit has risen by about 30 percent in the past 3 years.

(5) The extensive use of credit has been accompanied by a large increase in the money supply. Currency plus all deposits at commercial banks has increased by about 8 percent a year in the past 3 years.

Of course, one cannot add these separate developments together to get a measure of the overall pressure under which the economy has been operating because in certain respects they are reflections of one another; but certainly their net effect has been strongly expansive. And I think it should be clear (especially when we consider that we are operating closer to the overheating point than 3 years ago) that to continue on this same course of fiscal, credit, and monetary expansionism would risk producing a really very serious monetary imbalance in our economy. Indeed, one might say that the conditions of monetary imbalance have already been produced but for various reasons they have so far been reflected only to a limited extent in costs and prices. Whether these monetary pressures will erupt into significantly faster cost and price increases will depend in large part on whether the administration, and the monetary authorities, feel called upon to continue the expansionism practiced so far. This will depend, in turn, on their estimate of the 1965 outlook and on what they seek to achieve, by way of economic performance, in that year. Accordingly, let us examine the 1965 outlook and what it suggests as to policy.

(1) We may begin by acknowledging that the economy's advance has already slowed a bit but we should not attach too much importance to this, and should not jump to conclusions regarding the imminence of a downturn. There have been only relatively small increases in the rate of physical production since last July, even allowing for the impact of strikes, but I interpret this as a sign of a developing change in the economy's pace rather than as the preliminary to a downturn. It never pays to take the economy for granted, but there is nothing in the situation today that need mean more than, as I have put it, "a change of pace."

(2) It is true, also, that several of the indicators that give clues as to the future course of the economy have turned negative of late. New orders have been sliding off a bit; housing starts and building permits have been receding since early this year; commercial and industrial construction contracts have flattened out and seem to be working their way downward; and the stock market, which has not a bad record as a forecaster, has been rather jittery. The most recent compilation of the "leading" indicators, which carries the story through last October, showed only one out of six were at a high, as compared with about twice that proportion in August and September. But, again, and trying to avoid being incautious in reading the evidence, let me recall that on more than one recent occasion a weakening of the leading indicators has been a prelude to a flattening of the trend of the economy rather than to an actual downturn. Of course, if negative evidence mounts in the next few months I shall have to revise my views, but I do not propose to revise them in advance of the appearance of the evidence. I read the indicators today as saying that the pace of the economy is going to slow down a bit, no more than that.

(3) In my view, the most negative element in the outlook is that profit margins are coming under pressure. Labor costs per unit of output in manufacturing rose in October and the ratio of price to unit labor cost declined. What the latter indicates is that higher costs have not been entirely offset by price increases. It is not

surprising, therefore, that there was only a small increase in corporate profits (before taxes) in the second quarter of 1964 and almost no increase in the third quarter. This is not a reassuring development but in and of itself it does not spell downturn. It is not good news for the stock market, to be sure, but unless margins are squeezed a good bit more than they have been already they need not precipitate recession.

(4) There is also evidence that the business climate may be changing a bit in things that are happening in several of the major areas of gross national product. First, although forecasts are being made to the effect that business expenditures on plant and equipment may be 8-percent higher in 1965 than in 1964, there would be a year-to-year increase of close to 5 percent even if outlays were to remain through 1965 at their fourth-quarter 1964 level. In other words, we could have a good year-to-year increase and still have very little advance over present levels on a month-to-month or quarter-to-quarter basis. And this is probably what will happen. Second, new construction expenditures have been declining for some months and most of the 1965 forecasts contemplate a year-to-year increase that can be accounted for merely by the expected rise in building costs. Third, 1965 forecasts for consumer durables imply very little increases over present levels of production and sales.

(5) Finally, it is significant that when prices are increased nowadays the increases are in many cases made rather timorously. This is sometimes attributed to a fear of governmental displeasure but there seems also to be some doubt that the market can take price increases in stride. The same can be said of recent attempts to raise interest rates. Also, several U.S. officials have expressed concern that even a moderate tightening of credit might be more than the U.S. economy could stand. All of which suggests that reservations about the economic outlook are rather widely held.

An appraisal of the 1965 outlook is complicated by the fact that the economy is subject just now to certain short-term forces that are operating in opposite directions. The building up of steel inventories in anticipation of a possible steel strike in 1965 is tending to give the economy an abnormal upward thrust; on the other hand, strikes in the automobile and auto parts industries have tended recently to depress activity. All things considered, however, it seems clear that the underlying trend of the economy is moderately upward, that it will continue this way into 1965 and that its pace will be slower in 1965 than in 1964. Also, when one considers the effect that a steel strike can have on the economy, or even the mere anticipation of a strike, the chances are that 1965 will be somewhat rockier as a year than any we have had for some time. I want to emphasize, however, that this outlook is no basis for pessimism. On the contrary, the economy is strong today, it is expanding at least moderately and the forces making for growth over the longer term, which will be especially insistent in the second half of this decade, promise vigorous expansion far into the future.

If things work out as I expect they will, 1965 will serve as a year of consolidation, so to speak. And I think that is the way our economic policymarkers should construe it, as a year to consolidate our gains. As such, 1965 would provide a favorable basis on which to resume a faster rate of growth in the closing years of the decade. Call it a year for "regrouping," perhaps; but most important of all, as a period in which, after 4 years of heavily applied expansionism, we prepare for the high rates of family formation and labor force increase that will begin in 1966-67. To risk another analogy, 1965 should be construed by Government policymakers as a year in which we shift into a still higher speed gear or economic growth, with a moderate slowing of our advance in the process. Policy decisions will be critical in determining whether we make the shift smoothly. It should be possible to do so.

II. LABOR COST INCREASES AND THE CHANCES FOR EXTENDING OUR ECONOMIC EXPANSION

The "wage-price guideposts" that have been enunciated in connection with the relationship between labor cost advances and productivity improvements get a good deal more attention nowadays than these questions ever received before. But Government interest in noninflationary labor contract settlements is not new. Warnings against excessive cost increases were made repeatedly by President Eisenhower, especially after the inflationary labor contract settlements of 1955-56. In the Economic Report for January 1957, for example, it was stated that to ignore the need to keep wage improvements within the limits of average productivity gains would "* * * put the full burden of avoiding price inflation on monetary and fiscal policy" and that this would "* * * invite the risk of producing effects on the structure and functioning of our economy which might * * * impair the vitality of competitive enterprise." And a general guideline was laid down in the January 1960 Economic Report as it had been on earlier occasions, to the effect that "* * * settlements should not be such as to cause the national average of wage rate increases to exceed sustainable rates of improvement in national productivity."

Astonishing as this now seems, when these statements were first made they were criticized on the ground that cost increases had nothing to do with price inflation. Indeed, a rather common point of view was that the higher the labor cost increase the better for all concerned. It was even difficult to gain acceptance on analytical grounds for the view that the economy, and the interests of wage earners themselves, could be harmfully affected by excessive labor-cost increases. But the task of gaining acceptance of this view by labor groups was even greater, to put it mildly; and acceptance is as yet far from complete. But the view has survived and, beyond that, has assumed a rather different shape than it had in the 1950's. Because I have some reservations about its new shape, let me comment on the change that has taken place.

My reservations have to do with the way this view regarding the appropriate relationship between wages and productivity is being applied to the economy. Government policy began in this connection by being merely indicative; and its scope was pretty much limited to wages. Now, not only has it become a good deal more than merely "indicative," its scope has been widened to include an interest in prices and profits as well as in wages. Numerical indications have been given to what is officially regarded as "appropriate" for labor-cost increases; certainly, numerical indications have been strongly implied. These are the so-called wage guideposts. True, they have been surrounded by a forest of qualifications and exceptions, but they are far more explicit than the general warnings which they superseded. The earlier warnings were essentially qualitative; those we now have are essentially quantitative. And alongside this evolution from words to numbers has been an evolution toward a much more direct governmental interventionism.

Now, if we have only recently launched into number in these matters it is not because the merits and demerits of this approach were not examined earlier. We could have used numbers earlier but we didn't. First, we kept the approach broadly qualitative because of doubts that any specific number could be used equitably and constructively. Actually, the measurement of productivity, on which the determination of numerical wage guidelines depends, is a very complex and intricate statistical operation and the results so far achieved are quite imperfect. Our productivity measures are adequate for broad indicative purposes, but rarely for more than that.

Second, because there is a tremendous variety of conditions affecting different industries and different occupations, any number selected as a guidepost has to be surrounded by qualifications and exceptions to the point where one wonders what the guidance really is. In the end, what we have is not a guidepost but a catalog of guideposts from which different groups select models to their own liking.

Third, although numerical guideposts have proved in actual use to have a rather rubbery quality, and on occasion have been to all intents and purposes ignored officially, they have a tendency to commit Government so heavily to a given range of settlement costs that it makes Government involvement in specific wage contract negotiations more or less inevitable. It is not surprising that the past few years have been marked by more frequent and deeper involvement of the Federal Government in labor-management negotiations.

The danger of drifting toward labor market interventionism was not difficult to foresee. In his Economic Report of January 1960, President Eisenhower, in asking for better public understanding of wage-productivity relationships, warned of this possibility. And he stated that "* * * it would be a grave mistake to believe that we can substitute legislation or controls for [public] understanding." He pointed out that "* * * the complex relationships involved cannot be fixed by law and attempts to determine them by restrictive governmental action would jeopardize our freedoms and other conditions essential to sound economic growth." And the President had reasons to be sensitive on this question. We had had a bad case of labor-cost inflation in the 1950's, especially in the mid-1950's. Adjusted hourly earnings in manufacturing rose 5.3 percent in 1956 and 5.1 percent in 1957. And a troublesome degree of price inflation went along with this. The Consumer Price Index rose 3.5 percent in 1957 and nearly 3 percent in the following year. But these trends were stopped and conditions of cost and price stability were established with a minimum of direct intervention.

It most always takes time for policies, good or bad, to have their effect and it took time for the policies used in the late fifties to check cost-price inflation. But they did it, and when the result came it was beneficial. Indeed, stable costs and prices have been a major factor in the good performance of the economy in the last few years. Thus, with average productivity gains of something better than 3 percent, we had increases in adjusted hourly earnings in manufacturing industries of 2.5 percent in 1962, 2.6 percent in 1963, and 2.8 percent in the 12 months ending September 1964. This relationship between wage increases and productivity improvement accounts for the downtrend since 1961 in unit labor cost of production and for the improvement in the ratio of price to unit labor cost. It is not surprising that in this environment business profits have been rising, private investment expenditures have been increasing, the economy has grown at a good rate, and the real income of wage and salary workers has improved markedly.

The important question that faces us today is whether this good cost-price relationship is to be continued or whether we are on the threshold—perhaps even already a few steps over the threshold—of a new and less favorable chapter in the history of labor-management relations. One shouldn't be discouraged by one or two setbacks, however notable, but it must be conceded that the settlements reached last summer in the automobile industry suggest that we may be moving toward labor-cost increases similar to those that proved so troublesome in the mid- and later 1950's It has been repeatedly reported in the press that they involved cost increases in the neighborhood of 4.5 to 5.5 percent a year. It should be obvious that if such settlements become typical we will be squarely back to the annual labor-cost increases of the mid-1950's. If this happens we will find ourselves facing the same unhappy choice we faced in the mid-1950's; namely, between allowing cost and price increases to accelerate or applying monetary and fiscal restraints with the risk of slowing the Nation's economic growth.

The third choice, perhaps, is to intervene directly in the economy in the hope of somehow suppressing the cost and price increases that underlying market forces are bringing to the surface. There is a great deal of this in the world today and very little, in my opinion, to be said in its favor. In the first place, direct intervention weakens the market mechanism which regulates our economy. This mechanism can do its job very well if allowed to function freely; but it tends to atrophy when obstructed. In the second place, direct intervention creates distortions in the economy that lead to more and more intervention. It tends, in other words, to be a cumulative, self-aggravating process. Finally, unless direct intervention is supported by fiscal and monetary policies it won't work, anyway. At least it won't work for very long.

We have a good many illustrations of this in recent Western European experience. In an environment of full or nearly full employment, wage guideposts not supported by monetary and fiscal policies have come to grief, without exception. What has happened is that, under the pressure of rising demand, they have been extended first to a wider "incomes policy," intended to cover profits as well as wages, and then to price decisions as well as to decisions relating to wages. Typically, governments have been reluctant to support the guideposts with appropriate monetary and fiscal policies, on the ground that there was still excessive unemployment in some "area" or "pocket" of the country. But it has been repeatedly shown that fiscal and monetary expansionism doesn't reach structural unemployment; instead it produces harmful side effects.

I know of no way to break out of this expansionist syndrome except to recognize that the unemployment that remains in our economy at high points of expansion is due to structural conditions in labor markets not to an inadequacy of aggregate demand, and to acknowledge that we must use more sophisticated and selective measures to eliminate it. What we need is a change of emphasis: more emphasis on selective programs of job training, counseling, and placement; less emphasis on the blind expansion of aggregate demand and on "guideposts" to try to prevent the economy from doing what, under the circumstances of heavy demand, is the natural thing for it to do. Unless we learn to use a blend of noninflationary monetary and fiscal policies supplemented by selective vocational programs we will never master the wage-price spiral nor eliminate structural unemployment.

We are not so far down the guidepost road that there is not time to reset Government policy. I should like, therefore, to make a few suggestions to that end.

(1) Let me state again that no system of guideposts will work if it is not backed up by noninflationary monetary and fiscal policies. This is absolutely essential.

(2) Apart from the use of Taft-Hartley procedures in cases involving true national emergencies, we should limit Government participation in labor contract negotiations to the activities of the Federal Mediation and Conciliation Service. There is still time to turn back from practices, which have multiplied in the last few years, of White House or Cabinet-officer intervention in specific situations. We have an excellent instrument at hand in the Mediation and Conciliation Service. We should use it and support it.

(3) We should drastically revise our use of the so-called guideposts. Specifically, insofar as the Economic Report of the President deals with labor-management contract questions, it should limit itself to an evaluation of the experience of the past year. And, subject to the reservation that it is rarely constructive to single out specific cases, it should be quite quantitative in its treatment of the past year's record. In this respect, the more numbers the better. On the other hand, in dealing with the coming year's developments, the report's treatment of the subject should qualitative. In this case, the fewer numbers the better.

(4) It would be helpful if the Joint Economic Committee were to provide a special place in its annual review of the President's Economic Report for a critique of what the report says of the past year's wage-productivity history and what it proposes as a general qualitative guideline for the year ahead. Ample provision should be made in this review for all sides having an interest in these matters to express their opinion in public hearings.

This is perhaps as good a formula as we can devise for reaching an "incomes policy" that will both help reach the goals of the Employment Act and be consistent with a minimum of direct intervention in wage and price decisions. Supported by appropriate monetary and fiscal measures, and supplemented by a very generously financed program of selective vocational programs designed to get at the problem of structural unemployment, I think it would work. Its great merits would be that it would strengthen our traditional institutions of private enterprise, free markets and impersonal government.

III. A PROGRAM OF FISCAL AND MONETARY POLICY FOR 1965

Recent experience abroad has demonstrated that, while monetary and fiscal policy can for a time be basically expansive without causing price inflation if wage increases are kept well within the limits of productivity improvements, there comes a time when expansionist policies begin to produce harmful side effects. And if they are joined in this mischiefmaking by excessive wage increases, as has happened of late in Western Europe, the situation can become very difficult. Having in mind the outlook for our economy, what lines of policy should we follow in order to promote vigorous, noninflationary growth?

This is written at what is the critical season of the year as regards fiscal policy. In the relatively few days between now and January 1, 1965, the shape of Federal tax and expenditure policies for the next year and a half will be determined. What is done in these connections is always important, but this year—with the economy in a kind of animated suspension—it is especially so.

The important points to have in mind as we approach fiscal policy questions are that (i) the economy is operating at a high pitch with an outlook which, while not stunning, is still favorable; (ii) the Federal budget is still running a substantial deficit; and (iii) our international payments are still far from being in balance. With these points in mind, I would say that the aim of the fiscal 1966 budget-making exercise should be to move very deliberately in the direction of budget balance. True, the chances of achieving balance are not very bright; but we should move in that direction.

There is a point of view which maintains that a budget surplus always exerts a drag on the economy and that, if this drag begins to operate before full employment is reached, it becomes an obstacle to the achievement of that end. Those who take this view would doubtless say that a budget balance in fiscal 1966, and certainly a surplus, should be avoided like the plague. They would also, presumably, even oppose a move toward a surplus.

But I do not accept this concept of Federal budgeting; my quarrel with it is twofold. First, its advocates characteristically underestimate the degree of structural underutilization of resources, both of labor and of capital, that exists currently in the American economy. In my judgment they propose using an instrument—the expansion of aggregate demand through Federal budgetary deficits—that is too blunt to do the job of eliminating residual unemployment without producing harmful side effects in the economy. My second quarrel with the full-employment budget surplus concept is that it is a theory based on a single situation; namely, the 1959–61 experience, and that it attributes to fiscal policy results that I would attribute to a faulty, and not necessarily recurring, set of responses on the part of our financial system. The theory of fiscal policy with which we have always worked, and which I believe is still the most useful model, is that a surplus in the Federal budget will not be a drag on the economy—even where some nonstructural unemployment remains—because the savings generated in Federal accounts will move into private investment or into the financing of State and local government projects and help reduce unemployment. Thus, when an administrative budget was put forward in January 1960 which contemplated a surplus of $4.2 billion, it was explicitly stated that "* * * it would help meet demands for savings in credit and capital markets and thus facilitate and make less costly the financing of private and State and local investment projects important to economic growth and well-being." But a transfer of funds must take place if the Federal Government's savings are to be put to work in the private sector of the economy, or by State and local governments. And to this end, there must be reasonably prompt responses in interest rates and other credit costs and terms. The difficulty we ran into in 1960 was not that we had a surplus in Federal budgetary accounts. The difficulty was a slow financial response and a block to the flow of Federal savings into active private use. But, as I have indicated, this 1960 experience need not be repeated. I believe it has been a mistake to make it the basis of an entirely new approach to Federal budgeting. And when we realize that that new approach to Federal budgeting is typically coupled with a disbelief in structural unemployment, it is not hard to see that it can easily become a new formula for inflation.

But advocates of the full-employment budget surplus concept have no cause for anxiety over our having a large surplus in the Federal budget. On the contrary, it is presently estimated officially that there will be a deficit in the fiscal 1965 budget (administrative) of $5.7 billion. The question that has to be answered in this coming budget making season is whether a deliberate attempt will be made to reduce the amount of that deficit in fiscal 1966 and, if so, by how much, or whether an even larger deficit should be planned. And the latter choice could very well be made by those who follow the full-employment budget surplus concept. After all, they measure labor utilization by the overall unemployment rate and that rate is not very much lower today (5.0 percent in November 1964) than it was a year ago (5.6 percent in October 1963). But I don't regard this rate as useful for setting fiscal policy, and I would argue that our best course would be to move as far as feasible toward a budgetary balance in fiscal 1966. I believe this would be good for us, domestically, and it would be good for the dollar, internationally. And I think it would be constructive from the point of view of the rest of the world. The practical question is: What, all things considered, is it feasible to accomplish in fiscal 1966 by way of moving toward a balance?

First, we will be aided by the fact that Federal revenues can be expected to increase by several billion dollars as our economy grows. This is the "growth dividend," so to speak, of our Federal fiscal system. There are differences of opinion as to how much this revenue increase can be, but I would place it at $5 billion. It could be more and it could be less, depending on the rate of growth of current price GNP. Of course, if expenditures were held roughly at their current level, and if tax rates are not cut again, a $5 billion increase in revenues would almost close the deficit gap in fiscal 1966. But commitments have already been made to cut taxes and the President has publicly talked about spending requests totaling well over $100 billion. Our calculations must, therefore, take into account the volume of spending and possible changes in tax rates.

On the side of expenditures, it must be said that, barring very substantial economies, it is inevitable that spending will rise in fiscal 1966. For one thing, it will cost more to service the public debt. The debt is larger and interest rates, at least short-term rates, could average somewhat higher. Second, certain program costs are bound to rise. It will cost more, for example, to wage the war on poverty, for the simple reason that it takes time to spend money and the program has barely started as yet. Other expenditures will increase in view of the rising costs of personnel and materials; and spending will also be increased because of commitments already entered into under various Federal grant programs. To these nondiscretionary or "built-in" increases in spending we must add spending that will be added to the budget as a deliberate choice of policy. It is not easy to guess what these will be, but there is a very good chance that the total of nondiscretionary and deliberate increases will come to $4 billion.

Nor is it easy to estimate the offsets that one can expect against higher expenditures. These must be genuine spending reductions and increased sales of federally held financial assets. My best guess is that the balancing will result in a net increase in Federal expenditures of about $2 billion. This would increase administrative budget spending from the $97.2 billion estimated for the present fiscal year to $99.2 billion in fiscal 1966.

What about additional tax reduction? There has been much talk about more tax cuts. Indeed, last fall we seemed in danger of falling into a kind of tax reduction competition. In any case, the administration seems to be more or less committed, by its own choice, to a substantial reduction of excise taxes. Without going into details, it would be my guess that the cost will come to about $2 billion, that is, that we will eliminate virtually everything except taxes on tobacco, liquor, and gasoline.

The rest of the arithmetic is easy. If (i) we can count on a revenue increase or fiscal dividend of $5 billion; if (ii) we use $2 billion of this for a net expenditure increase; and if (iii) excise taxes are cut by $2 billion; then (iv) we have $1 billion left with which to reduce the deficit. This would mean a deficit of $4.7 billion in fiscal 1966 as compared with $5.7 billion in fiscal 1965.

This may seem like only a small improvement in our budget but a $4.7 billion deficit in the administrative budget would probably mean a cash deficit of about $2 billion. I would prefer a longer step toward balance, and if the fiscal dividend is $7 billion we would, other things equal, take a longer step. But $7 billion strikes me as a very liberal estimate of the likely revenue increase and I must conclude, therefore, that we will probably be left with a sizable administrative budget deficit. But we will at least be on the road to balance.

Turning to monetary policy, the most important point to note is that in the past 3 years we have had a veritable credit explosion. Every variety has been rising at high rates: in the latest 12-month period for which information is available, consumer installment credit increased 11 percent, home mortgage credit 9 percent, and bank loans to business enterprises 10 percent. And the increases in 1963 were 12, 9, and 10 percent, respectively.

One should not for a moment think that credit can expand at these rates indefinitely. A 10-percent expansion is about three times as fast as the physical growth of the economy. Clearly, at some point credit expansion must be moderated. Measured as the total of circulating currency and commercial bank deposits, money supply has been increasing this year at very close to an 8-percent rate. And in 1962 and 1963 the increases were 7.5 and 8 percent, respectively.

Now, unless one is prepared to argue that monetary expansion can go on indefinitely at this rate without producing serious inflationary results, an argument for which there would be no historical or analytical justification, it follows that we must at some point shift to a more moderate rate of credit expansion. And that should be the object of monetary policy in 1965. Naturally, the montary authorities must try to shift into a lower gear, so to speak, without interrupting the economy's advance, and it is not going to be easy to do this without rocking the economic boat a bit. But I believe it can be done, and I am sure that it should be.

To put it differently, we should aim to make 1965 a year in which we move to a sustainable rate of money supply expansion. Hopefully, the Federal Reserve System will pursue such a policy and will have administration support in the process. Also, it will need broad public support and vocal support within the Congress. The important thing is that we should avoid a prolongation of credit and monetary expansionism. A shift such as I am recommending to a slower rate of money supply increase would evoke protests from the expansionists, just as there were protests against a bank rate increase in Great Britain even in the face of a genuine emergency in its international payments. But the point is that we want a credit and monetary policy that will keep us out of the difficulties that Britain got into.

Another aspect of a current monetary policy warrants comment; namely, interest rates. The Federal Reserve Board's raising of its discount rate, following a British action to the same end, was the occasion for considerable public comment, for the most part rather Delphic in character, about the outlook for money and capital costs and about the role of Government in such matters. I see nothing wrong with the President expressing a judgment on private economic policies, including interest rate policies, any more than I see anything wrong with private individuals expressing judgments on public policies. But we would be well advised to avoid getting into a situation in which Government officials, and I should add, respectfully, that this must include the President, attempt to make the economic system do something other than what market forces are leading it to do. If market conditions warrant an increase in interest rates, an increase in interest rates should take place. The same must be said of wages and prices. If our policymakers are dissatisfied with the results of market forces, they should do something about the forces. And if they have reason to believe that the fault lies in the structure of the market, then in all logic and consistency they should do something about the structure of the market, whether it be the labor market, the markets for goods and services, or the money market. Actually, the Federal Reserve authorities, by working on market forces, have ample means to prevent money costs from rising. And as for the structure of the money market, I think we can say, without maintaining that it always works perfectly, that it works well enough to be left alone. Certainly, it is a vastly more competitive market than the market for labor. Anyone who believes as I do, that—except in cases of genuine national emergency of the Taft-Hartley type—we should avoid direct intervention in the labor market, certainly will oppose direct intervention in the credit and capital markets.

Actually, the intervention that did occur was unnecessary, anyway. As I judge the economic situation today, the demand for credit is not such that, considering the amount of credit available for use, any significant increase in interest rates or bond yields is likely to occur. Accordingly, I doubt that there would have been a general move to a higher level of interest rates, for prime borrowers or others, even if nothing had been said in Washington. And events are bearing this out. This is all the more reason for avoiding a policy of executive intervention and for placing our reliance on indirect measures of credit control and on the impersonal operation of market forces.

Summarizing, a constructive mix of private and public policy at this time would have the following ingredients. First, labor cost increases kept well within the limits of average productivity gains. It is absolutely crucial that settlements like those reached last summer in the auto industry should not become typical. Second, a Federal fiscal program that will move us a significant distance toward budgetary balance in fiscal 1966. Third, a monetary policy that will shift us to a distinctly less rapid rate of expansion of the money supply. Serious slippage with respect to any element in this mix would be a mistake. And if we move in the wrong direction as regards all three elements—with higher cost labor settlements, an increased Federal deficit and continued high rates of money supply expansion—we will most certainly be asking for trouble.

IV. RECENT INTERNATIONAL FINANCIAL DEVELOPMENTS AND THEIR SIGNIFICANCE FOR THE UNITED STATES

We have had occasion in recent days to see once again how economic policy decisions in the United States can be affected by happenings elsewhere in the world. Because it is for the moment the centerpiece of these events, let me begin with some comments on the British sterling crisis which occurred in the closing days of November.

An understanding of this incident requires that we note, first of all, the chronically precarious international financial position of Great Britain. Its exports of goods consistently fall short of its imports. When the current transactions in its international accounts have balanced out in recent years, or provided a surplus, it has been due to the favorable effect of the "invisibles" item in its trade accounts; that is, to the variety of shipping, insurance, financial, and other services which British companies perform for the world. But since the third quarter of 1963 Britain's balance on current transactions has been increasingly negative. And very large deficits have appeared of late as, with the British economy operating at an exceptionally high pitch, imports have risen far above exports.

Thus, if Britain is to maintain imports at present levels it must increase its exports. But to do this Britain must improve its competitiveness in world export markets. A recent article in Lloyds Bank Review (October 1964) reproduces figures which put British output per man-hour in 1960 at only 38 percent of the United States. This would be no problem competitively, if British wages were correspondingly lower than wages in the United States. But money wages in Great Britain, while lower than in the United States, are not as low relative to ours as is their productivity relative to ours. And the same unfavorable (to Britain) relationship between productivity and wages obtains between the United Kingdom and most continental Western European economies. The result is that, in many cases, British products are costly relative to similar products manufactured elsewhere. Competitiveness has other aspects than price, of course, but for the most part they are also unfavorable to Britain's position in export markets.

There is a demand factor in the picture, also. Britain's exports have increased in recent years, but not as fast as its imports. The latter have spurted recently, as incomes and demand have increased in the British economy. As a result, the trade gap has widened. It seems clear that at this point British economic policy has had an adverse effect on the Nation's balance of payments. That policy has been expansionist, with the Conservative as well as the present Labor government using aggregate demand as its major instrument for eliminating residual unemployment. I want to speak sympathetically on this matter, but it does look to me as if demand expansionism has been carried in Britain past the point of practical full employment and that damage has been done at the point at which Britain's economy is most vulnerable; namely, in its balance of payments. It is true that relatively high unemployment has tended to persist in some areas and in some occupational groups in Britain, but unemployment rates are currently between 1 and 2 percent for most broad industry groups. Construction seems to be the one exception, with a 3.2 percent unemployment rate, but this industry is commonly regarded as more than fully occupied. It looks as if recent economic policy in Britain is an example of how an effort to use aggregate demand to solve unemployment problems that are essentially structural can produce side effects, in this case a serious balance-of-payments crisis, without actually correcting the residual unemployment.

These are the basic elements in Britain's financial problem: (i) its production costs are high relative to those of its competitors and (ii) its domestic demand is outpacing its capacity to produce. The situation appears to have been worsened, however, by some additional factors. It seems to be a universal phenomenon for an incoming government, when it is taking the place of an opposition party, to complain about its "inheritance" of troubles. This is done, of course, with a hopeful eye to the history books. But it looks as though the Labor government's complaints about its legacy were carried too far. Those who follow the British press will know, also, that there has been much criticism of the Government's handling of the financial crisis. And certainly the early announcement of its intention to seek nationalization of the steel industry did nothing for confidence in the British pound.

There is no need to comment on these matters in detail. The point is that a combination of factors, some chronic and some acute but all unfavorable, produced a very serious disturbance of international financial relationships and that this was prevented from having still wider and more critical effects only by the fast action of a group of central banking institutions, national treasuries, and finance ministries.

What is the hopeful side of this story? It is that the situation presents the Labor government with an opportunity of which, in a certain sense, it is in a preferred position to take advantage. The opportunity is to get at the basic cause of the pound's weakness by launching an action program that will eliminate restrictive work practices in British industry. What is needed to improve competitiveness should be obvious. Basically, it is more work done per unit of wages paid, better prices on exports, more effort to sell abroad by more companies, and more reliable delivery.

Something needs to be done on the demand side of the problem, too. What is needed is a shift to a viable and less expansionist incomes policy. Another way to put it is to say that there is need for a stabilization program that will hold increases in demand to increases in physical output and which will reduce consumption demand for imports. Monetary and credit policy must provide parts of such a program; so must tax policy; and so must government expenditure policy. And in a certain sense budget policy is the most important element of all. The budget is the most complete and most revealing reflection of government thinking. If a government expects success in asking moderation by others, it must practice moderation in that over which it has closest control, and that is its own budget.

In short, the opportunity of the Prime Minister is to move Great Britain's production onto a basis of greater competitiveness and to take the leadership in a financial stabilization program. It should go without saying that this has to be done without touching off a deflationary spiral in the British economy, which would inevitably spread elsewhere and do no end of mischief. But difficult as it is to put the brakes on without shaking up the passengers, and without endangering other traffic, it should be possible to carry out a stabilization exercise successfully. The $3 billion credit gives time in which to do it with a minimum deflationary risk.

There are obvious connections between this latest European financial emergency and the development of the European Economic Community or Common Market. Clearly, the effect of the crisis in sterling has been to move the United Kingdom further from the Common Market than it was. Indeed, one of the most regrettable effects of British expansionism is that, by precipitating a balance-of-payments crisis, it has moved the country a long step away from the international trading community. I know no other way to describe Britain's imposition of a 15-percent surcharge on imports, which is tantamount to a doubling of its tariff walls.

All of this has meaning for the larger problem of Western European economic and political organization and for the international position of the United States. For one thing, it probably means that the Common Market will be increasingly "continental" in scope, which raises the risk that the EEC will become inward looking. And it further weakens the pattern of our international political and economic policy—the "grand design," as it has been called. The latter was already weakened by the failure of Britain's bid to join the Common Market, by apparent disappointments in the current round of tariff negotiations, and by the obvious difficulties encountered by our multilateral nuclear defense force proposal. What these events seem to suggest is that, politically, Western Europe will be oriented more and more toward an essentially continental federation, increasingly independent of U.S. influence.

Statement by Ben B. Seligman, Director, Department of Education and Research, Retail Clerks International Association, Washington, D.C.

It would appear that one of the essential requirements of a viable fiscal policy would be flexibility to provide for a quick response to changing circumstance. Toward that end, it would seem appropriate that some device such as standby powers for the executive branch to adjust tax rates be considered. Of course, Congress could set some upper and lower limits, but the range ought to be such as to allow the President to respond quickly to either deflationary or inflationary trends. In a situation of deflation in the private sector, a quick deduction in rates could provide the necessary stimulation; conversely, an inflationary trend could be headed off by an increase in rates to draw off any impending flow of "excess" income in relation to available goods. In a very real sense, such a device would parallel the present discretionary powers exemplified by the Federal Reserve Board's open market operations and its ability to alter reserve requirements. In this manner, the flexibility of the latter would be complemented by flexibility in fiscal policy.

Of course, there are numerous questions that deserve exploration: At what point in the shift in prices shall rates be changed? And how shall the "elasticity of response" be established? That is, by how much shall rates be altered? and in which income brackets? Which index ought to be employed to trigger the adjustment? Shall it be retail prices? Wholesale prices? Employment? To what degree does existing "flexibility" already provide for compensatory reactions, as when upward price movements carry people into higher brackets, thus increasing the tax take? There are many other questions, I'm sure.

However, let me say that this proposal is no panacea. It would be but one instrument in an entire toolkit. For in a case of high unemployment, even quick adjustment would not eliminate lagging responses. Hence, it would seem desirable that adjustable tax rates operated at the discretion (within limits) of the President be supplemented by a readiness to institute budgetary deficits. Moreover, the direction of such deficits should be clearly specified to provide the greatest payoff in terms of multiplier effects. Here, for example, public works and projects in the public sector would appear to be most effective, since the multiplier seems to be on the order of 2.7 as compared to about 2 say for space research. These comments are addressed to purely economic effects, but the question of public works and public services needs to be evaluated by other criteria as well. This, of course, takes us into the realm of the political.

STATEMENT BY CARL S. SHOUP, PROFESSOR OF ECONOMICS, COLUMBIA UNIVERSITY, NEW YORK, N.Y.

1. The most urgent fiscal policy issue is acceptance on the part of Congress and the public at large of the countercycle role of Federal taxation, to be exerted almost entirely by changes up and down in the personal income tax rates and perhaps also, though not often and in any case to a minor degree, by changes in the personal exemptions. It would be desirable to implement this role through a fairly well-defined formula, agreed upon in advance, by the relevant congressional committees. Such agreement would allow promptness of action at a time when economic conditions required it and the action taken could be disassociated from tax reform measures. Given this type of preparation by the Congress, it would not be necessary to delegate to the executive power to change tax rates.

Legislated changes in Government expenditure are likely to take more time than tax measures, both in enactment and in implementation, and should, therefore, be assigned a minor role in countercycle policy.

By "countercycle policy" I mean a policy designed both to check depressions and to dampen boom period inflations. Acceptance of countercycle fiscal policy implies a willingness to distinguish such a policy from a longer term tax and expenditure policy that cannot be planned for so readily by an agreed-on formula. Long-term changes in tax rates and expenditure levels become necessary because of long-term developments in the economy, including secular growth and substantial and permanent shifts in the level of Government expenditures: for example, as would occur if the defense picture changed materially.

2. Plans for countercycle fiscal policy need to include a consistent mix of deficit (or surplus) policy and accompanying monetary policy. This implies joint planning in advance for forthcoming booms and depressions by the Federal Reserve Board, the Treasury, and the Congress. The debate, at least the public debate, over the 1964 tax cut was a good illustration of lack of such coordinated analysis. The effects of a countercycle tax decrease depend largely on whether it is financed by increasing the money stock, by activating idle balances, or by neither.

3. Some increase in the built-in flexibility of the tax system can be achieved, but in general I would not look for much improvement in this direction. The chief measure yet to be taken on this score is a carryback of unused personal exemptions under the personal income tax. This measure is justified on equity grounds as well; it is, of course, a form of averaging.

4. Further exploration is needed of existing unemployment and part-time employment to ascertain the relative roles to be played in increasing employment by fiscal adjustments of a long-term nature, countercycle fiscal measures, and tax measures or Government ex-

penditure programs formulated for particular industries or occupational groups.

5. Regional disparities in unemployment and in economic growth in the United States need more analysis with a view to understanding whether they can be mitigated by particular tax or expenditure measures. The geographical uniformity clause in the Constitution applies to "duties, imposts, and excises," but not to "taxes," and the income tax amendment contains no geographical restriction. Other countries, notably England, France, and Italy, are using geographically differentiated tax measures to assist depressed areas.

6. In the field of tax reform, one of the most pressing needs is the linkage of personal income taxation at low-income levels to the welfare programs at and underneath those levels. There is at present much hardship and unfairness and occasionally disincentives to work due to certain crudities (notches, gaps, etc.) in the welfare programs, crudities of the type that are not tolerated in taxation. An imaginative attack on the entire problem of the fiscal regime of low-income individuals is needed, and it might show the way toward moving smoothly from negative taxes (welfare payments) into positive taxes, as incomes rise from extremely low levels to moderately low levels. In the process of doing this, many of the faults of the present welfare payment structure would probably be remedied. The social security experts, the fiscal policy experts, and the tax structure experts need to get together to work out a consistent program within these income levels.

7. Income tax reform needs to be pursued continuously, to be achieved probably in small amounts year by year over the next decade or so. Among the many items that require attention, importance attaches to (*a*) the question of optional modes of calculation available to the taxpayer, as under the proposed Long amendment and under the standard deduction; (*b*) the issue of more simplicity versus more complexity (I do not think the proper direction to choose is at all obvious at this point); and (*c*) the coordination of the corporate income tax with the personal income tax, including here the treatment of capital gains. The problems of tax exemption and low-rate taxation found with respect to State and local bond issues, depletion allowances, imputed income from homeownership, and so on, need to be studied continually, so that they can be brought up for consideration when and if the time appears propitious.

8. The relation of the Federal tax system to foreign trade, and to tax systems of other countries, will probably become an increasingly important issue. This includes such matters as whether there should be a rebate of income tax on exports and a compensating income tax levied on imports, whether the farm program embodies subsidies that are regarded as disturbing by certain foreign countries, and, of course, the whole question of foreign aid. The farm program and foreign aid may perhaps be set aside as not covered by the fiscal policy framework of the present inquiry. The treatment of exports and imports inevitably brings up for consideration the possible role of a general sales tax at the Federal level. I do not, myself, favor the tax measures just alluded to, but they will doubtless occupy much attention over the next few years.

9. The Federal-State-local fiscal structure will be a subject of continual discussion, as usual, but it will lead to substantial policy action only if the Federal Government finds its own fiscal position so easy that it can contemplate a program of additional grants-in-aid to the States and local governments. Such aid might be granted on any one of three grounds.

First, there are differentials between poor States and rich States so great that they require modification, which could be accomplished either by a geographically specialized program of Federal expenditures, or by a "small group" type of Federal grants-in-aid, namely, grants given only to the poorer States, nothing at all going to the wealthier States.

Second, it is probably somewhat easier for the Federal Government to raise the additional funds needed by States and localities than it is for those units to add to their already substantial property taxes and sales taxes. Part of the reason for this is that competition among the States, and among the local units, tends to prevent any one unit from reaching an optimum level of taxation. Grants-in-aid made on these grounds would go to all States, not just to the poor States, and they would go on a lump-sum basis or as per capita grants, not grants that would have an effect at the margin of local taxation as might the first type noted above. In other words, while the first type of grant might be formulated to induce additional revenue raising by the poor State or the poor local unit on the grounds that it could afford to do somewhat more if the Federal Government also helped, the second type of grant would not be designed to increase State and local tax collection, since indeed it would be formulated to take the place of such additional taxation.

Third, there may be particular programs that are financed by States and localities but that are of interest to the Nation as a whole because of the external effects that benefit people who are quite remote geographically from the State or locality where the expenditure is made. Education is a commonly cited example. Here the grants would be program grants for specific purposes, conditioned on need, ability and effort already being exerted to raise money by the State or locality. In any event, the grant to the States should not be a fixed percentage share of some Federal tax: for example, 10 percent of the Federal individual income tax revenue. Once the States obtain a vested interest in a particular Federal revenue source, the Federal Government's freedom of action in tax policy will become correspondingly restricted. If the individual income tax revenue were shared with the States, they would oppose reduction of the rates of that tax even when that reduction might be needed to stimulate the economy, and they would oppose structural reforms involving reduction in the revenue of that tax. The history of State and local attempts, successful so far, to block proposals to make interest on their bonds subject to the Federal income tax shows how seriously those bodies view any Federal fiscal measure that promises directly to impair their finances.

10. Urban finance will, no doubt, command much attention from Congress in the decade ahead. One question is whether the Federal Government should deal directly with the cities, thus bypassing the State governments. If direct dealing becomes the rule, it may be

necessary to require that several legally distinct cities that make up an urban area crossing one or more State lines form some sort of legally empowered urban district that can deal directly with the Federal Government. A further question will probably arise later; namely, whether such urban districts, or large cities (if no such legal districts develop), should gain almost complete financial independence from their State governments. Another issue is whether there are rich and poor urban districts to the same degree that there are rich and poor States, and, if not, whether the grants from the Federal Government should be restricted to program grants for certain specific services in each particular area. In the latter event, criteria need to be developed for specifying what services are to be aided; it is not clear, for example, why mass transportation rather than some other types of urban service should have priority in a claim for Federal grants.

11. While these points 1 to 10 are being considered, it will be well to keep in mind the need to maintain a Federal revenue system that is at least potentially strong, in the unhappy event that the international situation deteriorates. I suppose that we cannot rule out completely the possibility that an effective antimissile program will be developed, and will prove necessary some time in the next 10 or 15 years. In this event, an extensive shelter program will presumably be called for. Military control or at least surveillance of nearby space may become an issue. If the Soviet Union appears to be widening a lead in placing men on the moon, expenditure on this program may rise. Accordingly, we should keep the Federal revenue system potentially strong, to move into financing on a large scale if that proves necessary.

12. I should like to urge that the Federal Government set up a very large research organization to develop continuously an economic model of the U.S. economy so that at some time in the future we can appraise the results of past measures, and do a somewhat better job of forecasting than is now feasible. This is a long-term project, partly because of the relative scarcity of skilled economists available in this field, and partly because of the time needed to develop and test numerous economic relationships. It should be regarded, in this respect, in much the same way as the space program is viewed; namely, as an investment that will have little payout in the first 5 years or so but that will prove invaluable within a decade.

13. The present statement omits a great many issues that might be discussed, but it attempts to reflect my own views on priorities. The existing Federal tax system certainly causes an appreciable malallocation of resources, but, in a world of the second-best, this issue I think needs to be explored further before we decide how important it is as a matter of policy. To be sure, malallocation of resources is implicit in much of what we say about certain tax exemptions or tax privileges, but in these cases I am inclined to give great weight to equity considerations because of the potentially explosive social and political issues they embody. Incentives to work are, it seems to me fairly adequate throughout the country at the present time, as are also incentives to save. Incentives to invest, on the other hand, are probably of the first importance in the sense that the present tax system may well be inhibiting investment and favoring certain types of consumption more

than is really desired. At any rate, a thorough review of the whole growth question and its relation to the fiscal structure is needed. We should rethink what we mean by growth and how to measure it. We should also face the issue of determining at the expense of what other goals are we inclined to pursue growth, assuming that it is not a free good.

Statement by Leonard S. Silk, Senior Editor, Business Week, New York N.Y.

In my view, the principal issues likely to arise are these:

1. Should major emphasis be placed upon increasing Government expenditures or upon reducing taxes?

There now appears to be a consensus among responsible political leaders and leading economists that the budget should be balanced only when the economy is prosperous and prices are stable, and that, to sustain prosperity and facilitate economic growth, it would be desirable either to increase Government outlays or to reduce taxes at a pace consistent with the anticipated growth in real national output.

The choice among tax cuts and expenditure boosts will depend on many factors: Effects of either course, or some combination of both, upon the distribution of income; upon the efficiency of the economy; upon the overall growth rate or the solution of problems of particular regions or groups within the society; and the achievement of other major national objectives, such as maximum employment, national security, etc.

It is my belief that we must seek to build our budget and fiscal policies upon deeper and more complete knowledge of the choices facing us. We need to know more about the true costs (not only the dollar costs but the human costs) of undertaking different public or private activities; and we need to know more about the real social benefits of undertaking different programs.

I believe that your committee can be of tremendous value in developing more profound knowledge and public understanding of the major choices facing us as a nation. Decisions on fiscal policy go to the heart of those choices.

2. How should our existing tax system be reformed?

How can the tax system be made more equitable? Should we not expect different taxpayers earning the same income to pay approximately the same taxes? Or do we wish to favor or penalize particular types of taxpayers for the purpose of encouraging or discouraging certain types of activities? Can the tax system be made simpler?

3. How can fiscal policy be employed to increase the productivity and growth of our economy?

What is the impact of the corporate income tax on expenditures for new plant and equipment? Would further reduction in corporate income taxes stimulate business investment?

Would it be desirable to restructure the tax system to give extra stimulus to consumption or to investment? If, as some analyses suggest, capital-output ratios are declining, would it not be wise to adopt measures that would increase the growth of consumption relative to the growth of investment in order to maintain high employment and stable economic growth?

Improvements in technology and increases in scientific knowledge are basic to economic growth. How can tax or expenditure measures best be employed to stimulate research and development programs, particularly in technologically laggard industries?

Would a restructuring of our tax system involving a shift of emphasis from direct to indirect taxes (possibly including a value-added tax) increase economic growth? Would a tax system that promoted more equal distribution of income be likely to stimulate or retard growth?

4. What is the relation between our tax system and the U.S. balance of payments?

It appears probable that in the years immediately ahead we must continue to be concerned about avoiding sizable deficits in the U.S. balance of payments. Does our tax system help strain our balance of payments? Can the tax system be adapted to promote payments equilibrium? Should we, for instance, adopt measures to discourage investment abroad and encourage it at home? Should the interest equalization tax be continued after 1965? Should we propose to alter our tax system in order to be in a position to bargain with foreign governments for changes in their tax systems or trade practices that restrict the flow of U.S. exports?

5. What are the appropriate relations between fiscal and monetary policy?

Do we need new procedures, or a new policy body, for the control and coordination of fiscal and monetary policy? Would such control or coordination mean reducing the independence of the Federal Reserve Board? If so, would that be desirable or undesirable? What combinations of fiscal and monetary moves are possible to achieve different sets of national objectives, including economic growth, high employment, economic stability, price stability, and balance-of-payments equilibrium? Would a national incomes policy make a valuable adjunct to fiscal and monetary policy as a means of achieving these multiple, and to some extent, conflicting, national objectives?

6. Should the tax system or our budgetary expenditure policies be modified to achieve greater flexibility in order to promote greater economic stability at a high level of employment?

It would appear desirable to me to have a fiscal system that would respond more promptly to threats of inflation or recession. Can we create automatic devices to make the tax system more flexible in offsetting cyclical swings? Should there be a shelf of public programs that can be drawn from when the economy needs stimulation, or deferred when it needs restraint? Can the Congress, itself, find means for acting on tax or expenditure matters more promptly to promote economic stabilization? Can we, in effect, eliminate the business cycle from our economy? Would there be costs, especially in efficiency, involved in doing this? Would it further long-term creeping inflation? Would the gains from virtually eliminating the business cycle outweigh the costs?

7. *Is it possible to make the entire fiscal system of the United States, including not only the administrative budget but the social security and other trust funds, and State and local government expenditures and taxes, better adapted to the objectives of economic stabilization and growth?*

Have we adequate information on the impact of government spending and taxing at all levels? What is the implicit total government full-employment surplus? Will the social security funds, by running sizable surpluses in the decade ahead, provide a deflationary force that other Government fiscal policy must offset? Is is possible to make State and local expenditures and taxes reinforce the stabilizing effect of the Federal budget?

8. *How can adequate revenues best be provided to State and local governments, given their growing needs for funds to finance education, public facilities, etc?*

Do we need a system for regularly remitting a part of the yield of Federal taxes to the individual State governments? Would it be preferable to expand the existing system of Federal grants-in-aid?

What degree of control should the Federal Government in remitting funds to State governments exercise over their use?

In coping with such questions, I am sure that your subcommittee can contribute greatly to the economic education of the public. Though there has indeed been a growing common understanding of modern fiscal policy among economists and political leaders, I fear that much of the public remains greatly confused about budget deficits, the national debt, and many other matters affecting our Nation's prosperity and welfare. You can do much to clear up public ignorance of fiscal policy, and at the same time lay the basis for constructive new legislation.

STATEMENT BY WARREN L. SMITH, CHAIRMAN, DEPARTMENT OF ECONOMICS, THE UNIVERSITY OF MICHIGAN, ANN ARBOR, MICH.

I. NEED FOR FLEXIBILITY IN FISCAL POLICY

Our greatest need in fiscal policy is for greater flexibility. At the present time, we are still suffering from an unduly high rate of unemployment. Although structural measures to improve the functioning of the labor market are important, I believe the primary attack on unemployment must come through measures to expand aggregate demand to bring it into line with the economy's capacity to produce at an unemployment rate of 4 percent or, preferably, at an even lower unemployment rate if such a lower rate can be achieved without excessive inflationary tendencies. In my judgment, it is not yet clear whether the tax reductions provided for in the Revenue Act of 1964 will create a sufficient expansionary impetus to reduce unemployment to tolerable levels in the reasonably near future. If the impetus does not prove to be adequate, further expansionary fiscal measures, in the form or either tax cuts of expenditure increases, will be called for.

Once aggregate demand has been brought into line with productive capacity (defined in terms of an acceptable unemployment level), the problem will be to keep demand on target; that is, to see that the growth of demand neither exceeds the growth of capacity, with inflationary consequences, nor falls short of the growth of the capacity, thereby leading to an undue rise in unemployment. In many ways, the problems that will face us when demand and capacity have been brought into an appropriate balance will be considerably more delicate and difficult than the problems of the last 4 years. During the Kennedy-Johnson administration, it has been perfectly plain that the unemployment rate has been too high and the gap of unutilized productive capacity too large to be tolerable; and expansionary policies of a vigorous nature have, therefore, been clearly desirable. The problem has been to obtain legislative and public acceptance of sufficiently vigorous measures of expansion; there has been little danger that these measures would prove to be too strong, thereby resulting in inflation. When full employment has been achieved, we will be faced with the tricky problem of adapting our fiscal policy on a more or less continuous basis to the inevitable and to some extent unpredictable shifts in the various components of private demand, thereby steering a precarious course between the Scylla of inflation and the Charybdis of excessive unemployment. I believe it is technically possible to achieve a better performance in this regard than we have ever succeeded in attaining in the past, but this can be done only if we are prepared to make frequent and carefully timed adjustments in tax rates (or other parameters of the tax system) and/or in Government expenditures.

II. INFLEXIBILITY OF THE ANNUAL BUDGET

Our existing political and administrative arrangements make it extremely difficult for us to use the annual Federal budget as an effective instrument of fiscal policy, particularly at times when we seek to make the fine adjustments needed to maintain a continuing balance between the expansion of aggregate demand and of total productive capacity. It is necessary for the President and the executive branch to formulate a budget and present it to the Congress in January for the fiscal year beginning 6 months later on July 1. With the science of economic forecasting in its present state, it is extremely difficult to judge with any degree of certainty at the time the annual budget is being put together in the executive branch what the state of the economy will be some 8 months or more later when the budget is due to go into effect. Again, this forecasting difficulty is especially acute at a time when demand and capacity are relatively finely attuned and the problem is to keep them that way in the coming months. Furthermore, the budget as presented to the Congress by the President is really no more than a tentative statement of the administration's financial plans for the following year. The individual expenditure items in the budget are subject to piecemeal consideration by the Congress and its various committees with no provision for congressional consideration of the budget as a whole and its fiscal implications for the maintenance of a balanced economy. Inevitably many proposals affecting the budget will be altered or rejected by the Congress, and new proposals not foreseen by the President may be invented and put into effect, so that the result forthcoming after the completion of congressional consideration of the administration proposals is likely to differ very substantially from the budget originally presented to the Congress in January. In addition to these difficulties, no provision is made for systematic annual consideration of taxes from the standpoint of their impact on private demand for goods and services.

The cumbersomeness of our budgetary machinery is well brought out by a contrast with the situation that prevails in Britain. The British fiscal year begins on April 1, and the Prime Minister ordinarily presents his budget to the Parliament in late March or early April, that is at the very beginning of the fiscal year to which the budget applies. This makes it possible to formulate the budget with a much better idea concerning the economic outlook and problems during the period to which the budget applies than is possible in this country. Moreover, the British budget is a comprehensive financial plan covering both expenditures and taxation, and the budget as a whole is formulated with a specific view to having a desired impact on the level of aggregate demand. Finally, unless a major political crisis occurs, which is most uncommon, the British parliamentary system insures that the budget as presented by the Prime Minister will be acted upon promptly by the Parliament and put into effect without significant change. It is also worthy of note that in Britain there is little or no emphasis on the objective of balancing the budget as an end in itself; that is, the view that the budget is an important instrument of economic regulation has been generally accepted by Government officials of both parties as well as by the general public, and it seems to be agreed that whether the budget should show a deficit or a surplus should depend on the state of the economy.

III. IMPLICATIONS OF THE BALANCE-OF-PAYMENTS CONSTRAINT ON MONETARY POLICY

In the last 5 years or so, our balance-of-payments situation has imposed a rather severe constraint on the use of monetary policy as a means of stabilizing the domestic economy—a constraint which, fortunately, was not present in earlier years. This limitation on our freedom to use monetary policy in a flexible way to achieve domestic goals seems almost certain to continue in the years to come, and this makes it even more important than in earlier times that we achieve greater flexibility in the use of fiscal policy. Moreover, even in the absence of a balance-of-payments constraint, there is, in my judgment, a tendency in some quarters to exaggerate the potency of monetary policy as a device for maintaining economic stability. Trivial variations in interest rates and in the rate of growth of the stock of money, which are scarcely capable of having any significant effect on the state of the economy, are frequently endowed with an unjustifiable significance. Economic analysis suggests that the effects of monetary policy work primarily through interest rates—or through changes in credit availability, which will ordinarily be reflected in interest rate changes. Such evidence as is available indicates that monetary measures must produce substantial changes in the interest rates in order to have significant effects on income and employment, and that even such effects as monetary measures do have make themselves felt only after a considerable lapse of time. When the balance-of-payments considerations do not limit its flexibility, monetary policy is able to make a modest contribution to economic stabilization; however, even under these circumstances, it is scarcely able to carry the burden alone.

IV. EXECUTIVE INITIATION OF ADJUSTMENTS IN PERSONAL INCOME TAX RATES

In my opinion, the best way to increase the effectiveness and flexibility of fiscal policy would be to establish some procedure whereby the President could initiate temporary changes in personal income tax rates when economic conditions seemed to call for such action. A proposal along these lines was perhaps the most important recommendation contained in the 1961 report of the Commission on Money and Credit, a body composed of prominent private citizens from many walks of life operating under the sponsorship of the Committee for Economic Development and the Ford Foundation. A somewhat similar proposal, although differing in its specifics, was advanced by President Kennedy in early 1962 and was spelled out in some detail in the January 1962 Economic Report (pp. 74–76). The latter proposal was also recommended in the 1963 and 1964 Economic Reports, but it has apparently attracted little support in the Congress. Both the CMC and the administration proposals were hedged about with conditions designed to prevent executive abuse of the authority and provided that the Congress could veto an executive proposal for a change in tax rates if it thought the proposal was inappropriate.

Despite these limitations and protections, I can understand and appreciate that Members of the Congress may well regard these proposals as an infringement of normal legislative prerogatives with respect to taxation. However, there may be other ways to accomplish the purposes of these proposals in ways that the Congress would find less objectionable. For example, a procedure might be established under which the President could, under certain specified conditions, recommend an increase or decrease in personal income tax rates in accordance with a prearranged formula, together with a corresponding appropriate change in the withholding rate. The Congress could establish a special legislative procedure which would guarantee that prompt action one way or the other would be taken on the President's proposal. By giving the Congress a more positive role than is provided for in the CMC or administration proposals, such a plan might meet with less objection in the Congress. But, however the details might be worked out, the establishment of some procedure for increasing the short-run adjustability of personal income tax rates is, in my judgment, an absolutely vital requirement if we are to be able to do a better job of maintaining high levels of employment and reasonable stability of the price level on a continuing basis. The development of a detailed proposal to accomplish this purpose provides an opportunity for constructive and imaginative "political-economic engineering" of the highest order. I was pleased to see that Secretary of the Treasury Dillon, in a speech delivered at the Harvard Business School on June 6 of this year, referred to the need to increase the countercyclical flexibility of tax policy as "a major piece of unfinished business."

V. FISCAL POLICIES TO INFLUENCE INVESTMENT

Personal income tax adjustments of the sort referred to above would have their primary impact effects on personal consumption expenditures. If we are to be able to do a fully effective job of maintaining economic stability, I believe we will also have to be able to exert some influence over levels of private investment. Investment is inherently a cyclically volatile component of GNP, and we are likely to have difficulties at times arising from a tendency for investment in certain sectors or industries of the economy to rise more rapidly than product demand expands in those sectors or industries, thereby leading to excess capacity and recessionary tendencies. This seems to have happened, for example, in the later stages of the 1954–57 expansion and to have been an important cause of the 1957 downturn. Furthermore, if we are interested in accelerating the longer-term growth of the economy—i.e., the growth of its productive capacity—we shall need some means of increasing the proportion of GNP going to private investment, a proportion which has fallen noticeably below the level that prevailed in the earlier postwar years of more rapid growth. Thus, in the interest of both shortrun stability and longrun growth, we shall need some instrument capable of exerting an effective influence over the general level of private investment.

In the absence of a balance-of-payments constraint, monetary policy, which undoubtedly has its primary impact effects on the various components of investment expenditures, might, in principle at least, be capable of fulfilling this role. However, as indicated above, I believe the effectiveness of monetary policy as a means of influencing private investment, particularly in a short-run cyclical context, has been exaggerated. Moreover, as also indicated above, for the present and the foreseeable future, the balance-of-payments situation is likely to place significant limitations on our freedom to make use of monetary policy for the purpose indicated. Accordingly, I believe the effectiveness of stabilization policy could be substantially improved if we could develop a flexible fiscal device which would be capable of exerting a prompt and significant influence on levels of private investment. Although I do not feel able to make a recommendation in this connection with the same degree of confidence that applies to my support of a flexible procedure for adjusting personal income tax rates as outlined above, I believe the possibility of giving the President some limited authority to initiate variations, as circumstances might warrant, in the investment tax credit established by the Revenue Act of 1962 above or below the 7-percent rate that now prevails is worthy of serious study and consideration.

VI. SECULAR ADJUSTMENTS OF TAXES AND EXPENDITURES

There is one aspect of the relation between fiscal policy and economic growth that is deserving of explicit discussion. According to the estimates of the Council of Economic Advisers, the productive capacity of the economy—defined as the GNP valued at constant prices which can be produced when the economy is operating at an unemployment rate of 4 percent—has been growing at a rate of about 3½ percent per year recently. Assuming an upward drift of the implicit price deflator of GNP of about 1½ percent per year, such as we have been experiencing in the last few years, GNP, valued at current prices, will have to rise at a rate of about 5 percent per year once we have reduced the unemployment rate to 4 percent if we are to hold the rate at that level. A 5-percent rate of increase in GNP, starting from the present capacity level, would mean an annual increase of $30 to $35 billion per year. With our present tax system, the sensitivity of tax collections to rising incomes is such that a rise of this magnitude would bring in about $6 to $7 billion per year of additional tax revenues. (If measures were adopted to increase the growth of capacity—by channeling more resources into investment, research and development, and education—the secular growth of tax receipts at full employment with the present tax structure would be even more rapid.) Except in periods when the basic forces of private demand were unusually buoyant, a rise in tax revenues of this magnitude, unless offset by a roughly corresponding increase in Government expenditures, would gradually come to exert a "braking" effect on economic expansion which would make it impossible to keep the economy operating steadily at capacity levels. Indeed, just such a fiscal brake was operating between 1957 and 1964 when the rise in revenues that would have been generated had the economy continued to operate at high levels of employment was unmatched by expansion in Government expenditures, with the result that the economy was dragged downward to chronically intolerable levels of unemployment.

It is apparent that, if we are to maintain a healthy pace of economic growth in the years ahead, we must be prepared either (*a*) to increase Government expenditures more or less in line with the rising tax revenues that will be generated at high levels of employment, or (*b*) to make further downward adjustments in tax rates from time to time similar to those embodied in the Revenue Act of 1964. This problem of the secular fiscal brake that may be applied to the economy as a result of rising tax revenues generated by economic growth should be distinguished sharply from the problem of cyclical instability which may call for periodic temporary increases or decreases in tax rates, as referred to above. The tax adjustments—if we choose to use the method of tax reduction—needed to moderate the secular braking effect of the tax system should be permanent reductions in taxes, and it is appropriate to use the occasions on which such reductions are called for to introduce needed reforms into the tax system.

It will certainly be appropriate at times to counteract the braking effects of additional tax revenues generated by economic growth through increases in Government expenditures, at least in part. Indeed, the process of economic growth might proceed more smoothly if Government expenditures were to grow year by year more or less in pace with the overall growth of GNP. However, Government expenditures should not be increased unless the social wants that these expenditures satisfy in the public sector are felt to have a higher priority than the private expenditures that would be stimulated by the alternative measure of tax reduction. But, apart from the possibility of large cuts in defense spending that might prove to be possible if world tensions should ease substantially, it seems clear that increasing Government spending will prove to be necessary over the years ahead to meet the needs of a growing and increasingly urbanized and interdependent economy and nation. There would be considerable advantages from the standpoint of maintaining stable economic growth if the required increases in Government spending could be planned and programed ahead for a number of years, since this would presumably mean that the important Government-expenditure element of GNP would constitute a predictably expending component of final demand.

VII. FEDERAL GRANTS-IN-AID

Growing educational demands, together with the urgent necessity for vigorous measures to deal with slum-clearance and general urban blight, are certain to place an increasingly crushing burden on many of our State and local government units in the next few years. If these problems are to be dealt with effectively, it will be necessary either to increase substantially the financial resources available to State and local governments or else to have the Federal Government intervene directly through expenditure programs directed at their solution. One line of attack on these problems which has a great deal of merit is through a considerably expanded Federal program of grants-in-aid to State and local governments to help them fulfill their responsibilities. This approach should have a good deal of attraction for those who are fearful of a continued expansion in the activities and responsibilities of the Federal Government itself. If such a program were to be effective, the grants would need to be scaled according to need, as measured perhaps by the per capita income of the State. In addition, there would have to be safeguards to insure that Federal aid was not used by State and local governments simply as a means of reducing the tax burdens on their own citizens. This might be done by making the grants depend upon the fraction of a State's income taken by State and local taxation. In my judgment, it would also be desirable for the Federal Government to exercise some control over the uses to which the grant funds were put by State and local government units and to establish some minimal standards applicable to the educational and social service programs of the States and their subdivisions to the extent that these programs were financed by Federal grants.

VIII. CONTINUED NEED FOR TAX REFORM

While the tax reduction provided for in the Revenue Act of 1964 has already been and will continue to be a great benefit to the economy, it is most unfortunate that the Congress saw fit to eliminate most of the structural reforms included in the administration's original tax reduction-reform bill. Tax reform in such areas as the treatment of capital gains, excessively liberal allowances for depletion of mineral resources, and the allowance of numerous unjustifiable deductions under the individual income tax is still urgently called for. However, I believe the case for tax reform should rest primarily on grounds of equity. The effects of structural reforms of the tax system on economic stability and growth are quite complex, difficult to identify and measure, and, in all probability, decidedly on the second order of importance.

IX. STUDIES OF THE IMPACT OF FISCAL POLICY

The tax adjustments that have been made since 1962 provide us with a good opportunity for a careful study of the fiscal impact on consumption and investment expenditures of various types of tax changes. Careful studies of the effects on business investment of the 7-percent investment tax credit, as enacted in the Revenue Act of 1962 and modified in the Revenue Act of 1964, would be of great value. In addition, there is need for detailed studies of the effects of the reductions in individual and corporate tax liabilities provided for in the Revenue Act of 1964. In the latter connection, an extensive study, employing sample surveys, aimed at isolating and analyzing the consumption effects of the reduction of individual income taxes, is now underway at the Survey Research Center of the University of Michigan.

X. USEFULNESS OF THE "FULL-EMPLOYMENT SURPLUS" ANALYSIS

I do not believe that the full-employment surplus type of analysis is of any great value as an aid to policy formulation. Its value is rather primarily the pedagogical one of helping the layman, untutored in the refinements of economic analysis, to understand the important difference between passive budget surpluses and deficits, which result primarily from changing tax receipts as income rises and falls with a given tax-expenditure structure, and active surpluses and deficits that result from changes in tax legislation and changes in Government expenditure programs.

The full employment surplus actually tells only one thing: The amount by which gross private domestic investment (plus net exports, to be exact) must exceed gross private saving at full employment. This is not a useful piece of information. It does not show what level of private investment is needed for full employment. An increase in both Government expenditures and full-employment tax receipts will increase the required amount of investment. (These relationships follow from the balanced-budget-multiplier principle, which is accepted by most students of fiscal policy and is supported by evidence drawn from econometric models.) Nor, it seems to me, does knowledge of the full-employment surplus even facilitate the calculation of the amount of investment needed to maintain full employment. As indicated earlier, the full-employment surplus has sometimes been used as an expository device to distinguish the automatic changes in revenues and expenditures that occur because of changes in income with a given tax-expenditure structure from discretionary changes that occur when the Government varies tax rates and expenditure programs. This use was made of the concept on pages 78–81 of the January 1962 Economic Report of the President and particularly in chart 6 on page 79, which uses this technique to compare the economic impacts of the budget in fiscal 1960 and fiscal 1962. Assuming (as in chart 6) that there is approximately a linear relation between the Federal deficit or surplus and the level of GNP (both taken either absolutely or as a percent of potential GNP), two constants are needed to fix the required straight line. The two constants commonly used to determine a line are the slope and the intercept on the vertical axis. However, since the intercept on the vertical axis in this instance has no economic significance, it is more meaningful to use the full-employment surplus along with the slope to determine the line. Then movements along a given line resulting from changes in GNP represent automatic changes in taxes and expenditures, while shifts in the line produced by fiscal measures which change the full-employment surplus are taken to represent discretionary fiscal policy. This use of the full-employment surplus may be of considerable value in a simple explanation of the rudiments of fiscal policy for the benefit of the general public. But use of the concept as a device for precise analysis of the impact of fiscal policy measures is subject to two serious objections:

1. Any given change in the full-employment surplus and corresponding shift in the budget-GNP line can, in principle, be produced by (*a*) a change in Government expenditure programs; (*b*) a change in tax legislation; or (*c*) various combinations of (*a*) and (*b*). Unfortunately, however, the economic impact of a given change in the full-employment surplus will vary depending on how the change is produced, since the leverage (i.e., multiplier effects) of a given change in Government expenditures is usually agreed to be greater than the leverage produced by the same change (in the opposite direction) in tax revenues. While for practical purposes it is reasonably safe to say that an increase in the full-employment surplus is deflationary and a decrease expansionary, even the direction of the effect is not completely unambiguous, since it is possible to concoct combinations of expenditure adjustments and tax adjustments which will be deflationary and at the same time reduce the full-employment surplus, or vice versa.

2. While changes in expenditure programs may, to a first approximation at least, be viewed as shifting the level of the budget-GNP line without changing its slope, it is difficult to imagine any kind of change in tax legislation that would be of practical significance which would not change the slope as well as the level of the line. The slope depends upon (*a*) the way in which the level and distribution of taxable incomes change as GNP changes and (*b*) the provisions of the tax laws which determine how tax liabilities change as the level and distribution of taxable income change. Hence any change which affects the progressivity of the tax system will change the slope of the budget-GNP line. And almost any change in the tax system will affect progressivity. For example, even an increase in the personal exemption will reduce tax liabilities by a larger proportion (even though by a smaller absolute amount) for low-income than for high-income individuals, thereby increasing progression and steepening the slope of the tax-GNP line. About the only kind of tax adjustment that would not affect the slope would be a lump-sum change in taxes by the same amount for all taxpayers, and such a tax change is obviously of no practical significance. The fact that discretionary tax changes can—and in practice always do—change both the level and the slope of the relation between taxes an GNP means that changes in the full-employment surplus cannot be used to depict discretionary changes in fiscal policy brought about by adjusting taxes. For example, by appropriate adjustments in the rate structure, exemptions, and other tax provisions, it is possible to reduce taxes at the current level of income and thereby provide an immediate expansionary stimulus while at the same time (*a*) reducing the full-employment surplus, or (*b*) increasing it, or (*c*) leaving it unchanged.

The positive disadvantage of extensive use of the full-employment surplus as an analytical tool in discussing fiscal policy is that it focuses attention on the surplus (or deficit) as the moving force of fiscal policy.

For example, economists who advocate vigorous use of fiscal policy are often said to want a deficit per se at a time of high unemployment like the present, while others—especially conservatives—who accept the need for action, emphasize that they disagree in the sense that they view the deficit as an unfortunate price that must be paid for proper fiscal policy. Actually, neither view is the right one. We should look upon the deficit as merely a resultant of decisions concerning fiscal policy (or, more broadly, concerning the fiscal-monetary mix)—choices that should be made on the basis of their effects on employment, growth, price stability, and so on, without explicit regard to their effects on the deficit or surplus per se. (It is conceivable that, if the debt and interest payments were very large relative to national income, the deficit itself might be a legitimate object of concern. But such a situation certainly does not exist today.) In addition, undue emphasis on deficits (and surpluses) leads to the view that deficits are inflationary (and presumably surpluses deflationary, although this is less often emphasized). Actually, of course, a deficit is just a deficit and neither inflationary nor deflationary. It is changes in deficits or surpluses—or, more correctly, in the underlying tax and expenditure components—that may have inflationary or deflationary effects.

Basically, the objection to the full-employment surplus analysis is that it attempts to boil fiscal policy down to a single number. While this may be possible for purposes of rudimentary exposition, such an oversimplified approach is of little value in actual policy informulation. For operational purposes, the focus needs to be placed on the effects of changes in various kinds of Government expenditures and the effects of various types of changes that may be made in taxation. While we are far from having a full understanding of the complexities and subtleties of fiscal policy, probably the best we can do in the present state of economic knowledge is to rely on the answers given by a full structural econometric model of the U.S. economy (such as the one that has been developed by the Research Seminar in Quantitative Economics at the University of Michigan), supplemented by the judgment of seasoned observers.

STATEMENT BY BERYL W. SPRINKEL, VICE PRESIDENT AND ECONOMIST, HARRIS TRUST & SAVINGS BANK, CHICAGO, ILL.

I am flattered to be invited to participate in a survey to determine the important fiscal policy issues likely to face Congress in the next decade. Unfortunately, my professional competency lies primarily in the monetary policy area rather than fiscal policy.

There is one issue, however, that I would like to suggest that the committee consider in some detail since it does overlap my area of special knowledge. Although we hear frequent references to the stimulating effect of large budget deficits and the restrictive effect of large budget surpluses, I think there has been a noticeable lack of careful testing of this hypothesis. If we are going to place so much emphasis on fiscal policy as a stimulant, then it strikes me that we should have a much better view than is currently the case as to the ultimate effect of action in this area. During the postwar period we have had three major tax cuts in this country, one in 1948, one in 1954 and one this year. In the last two periods the tax cuts were followed by a strong economic trend. In 1948 the tax cut was shortly followed by a recession. Although the size of the tax cuts varied considerably in terms of absolute dollars, they were approximately the same size relative to the size of the economy. Monetary analysis suggests that the reason for the recession following the 1948 tax cut was the contracting money supply then in evidence. In the latter two periods monetary policy was expansive and the economy strengthened. Based on the limited evidence which I have observed, it is my tentative opinion that far too much emphasis is placed on fiscal policy as an economic stimulant or depressor and that too little emphasis is placed upon the effects of monetary policy. However, this is an important undecided issue and it would well warrant investigation by competent technicians on the committee staff.

For an elaboration of my views on this important controversy, I refer the reader to the following papers:

1. "Role of Monetary Fiscal Policies," address presented to Farm Foundation annual meeting, Lincoln, Nebr., September 10, 1963, available in mimeograph.
2. "Financing the Deficit," with Dr. Herbert E. Neil, Jr., in the Tax Foundation: Tax Review, vol. XXIV, No. 9, September 1963.
3. "Relative Economic Growth Rates and Fiscal-Monetary Policies," in the Journal of Political Economy, vol. LXXI, No. 2, April 1963.

Statement by Lazare Teper, Director, Research Department, International Ladies' Garment Workers' Union, New York, N.Y.

National fiscal policy should continually be geared to maintaining a rate of economic growth adequate to keep unemployment at a minimum, consistent with the objectives of the Employment Act of 1946. An active fiscal policy to this end is particularly important because of the rapidly increasing labor force and rapid technological displacement of manpower.

The tax cut enacted early in 1964 helped to sustain economic growth. However, much more remains to be done. The tax reforms recommended by President Kennedy and the AFL–CIO should have a high place on the fiscal agenda. In addition, continued watchfulness is required lest the tax system act as a brake on necessary expansion. The Federal budget should not be allowed to depress economic growth. At the same time, there exists a continued need to review budgetary practices to assure that Federal fiscal policy exerts an anticyclical influence.

A long-range fiscal policy of stimulating economic growth should recognize the need to increase investment in education, health, housing, mass transportation, conservation of natural resources, and recreational facilities. Particular emphasis must be placed on urban problems which have been too long neglected and in which the chief pockets of poverty are to be found. The overall public works program is justified both as a stimulant to economic growth and also by the needs of our growing population. However, since much of the activity in this field will be conducted by State and local governments, consideration should be given to ways of diverting some share of Federal revenues to them on the assumption that appropriate Federal standards and conditions under which such funds can be used will be spelled out in the appropriate legislation.

When tax reductions are considered desirable in order to stimulate the economy, it is important to assure that added spending power generated by such moves should affect the economy quickly. Tax relief in the middle- and low-income brackets must, therefore, be given chief priority. As a first step, consideration ought to be centered on the reduction and/or elimination of indirect taxes such as sales and excise taxes on essential goods and services—since these are borne to a relatively high degree by the moderate- and low-income families. As the next step, income tax reductions should be sought by raising individual exemptions and lowering tax rates on moderate and low incomes. The need to lower business taxes is minor in this regard. The increased demand for goods and services resulting from the direct and indirect tax cuts suggested above is likely to augment business profits and provide the needed incentives for increased business investment in new plant and equipment.

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The present size of the national debt is not a threat to the national well-being. In proportion to gross national product, it has been steadily shrinking and the interest costs progressively loom relatively smaller. Any substantial reduction in the national debt would merely have serious deflationary consequences. As a matter of fact, a sound long-range fiscal policy, predicated on a growing population and gross national product, would require moderate increases in the national debt over a period of time.

There is a need to modernize a number of collateral programs that have an impact on fiscal policy. Social security and unemployment insurance, as automatic economic stabilizers, should be strengthened. A higher level of benefits, adequate provision of medical and hospital care, and development of Federal standards in the case of unemployment insurance are an essential part of a long-term economic policy. Increased minimum wage and extension of coverage under the Fair Labor Standards Act would also help to safeguard purchasing power and consequently stimulate business activity.

Our balance-of-payments problem has not been brought on by the failure of our sales abroad to exceed imports. The major contribution to the balance-of-payments problem has been the outflow of American funds abroad. The real issue here is the world's confidence in the growth potential of the American economy. A rapidly growing domestic economy would provide the best solution to our balance-of-payments problem.

Statement by George Terborgh, Research Director, Machinery & Allied Products Institute, Washington, D.C.

Since I am not a tax expert, I shall confine my suggestions to the single broad topic of economic stimulation and stabilization through Federal fiscal policy. The Revenue Act of 1964 represents the first acknowledged and deliberate effort to employ fiscal policy for the purpose of economic control, but it will certainly not be the last. At present we are woefully ignorant about the efficacy of fiscal policy, and about the indicia and criteria for its employment, not to say criteria for the proper "dosage." I suggest the importance of a careful review of past experience on the relation between the Federal budget position and business trends. I suggest also the desirability of making careful analysis of the effects of the tax cut in the Revenue Act of 1964.

Another aspect of this problem that needs further investigation is the relation between fiscal and monetary policy. What is the proper "mix" of the two? I have the feeling that we may be overworking fiscal policy at the expense of monetary policy.

Finally, I should like to suggest the importance of the question of achieving greater flexibility in the application of fiscal policy. Present procedures of committee hearings and prolonged legislative delay are obviously poorly adapted to a prompt and flexible application of fiscal policy.

Statement by James Tobin, Professor of Economics, Yale University, New Haven, Conn.

Here are my thoughts on fiscal policy issues which the Congress should be considering:

1. *Increased flexibility in Federal taxation.*—Both the Commission on Money and Credit in 1961 and President Kennedy in 1962 recommended measures to adjust Federal tax rates quickly in the short run. The purpose is to increase the contribution fiscal policy can make to economic stabilization. This is still, in my view, an important objective, especially because international considerations are making monetary policy a less flexible instrument for internal economic stability. The administration's 1962 proposals may involve unacceptable delegation of power from Congress to the President. But I am confident that ways can be found which accomplish the purpose without such delegation of power.

2. *Desirable longrun distribution of revenue increases and defense budget savings.*—The growth of the economy—apart from business cycles—will increase Federal revenues by $5 to $6 billion a year. Also, international and military developments may permit savings in the defense budget. How should these be allocated among (*a*) tax reductions; (*b*) increases in civilian expenditures; (*c*) grants to States and local governments, conditional or unconditional; and (*d*) reductions in Federal deficits and debt?

A number of central economic issues are involved: To what extent can private spending, in particular business investment, be expected to make up for a reduction in the Federal full employment budget deficit? To what extent can easier monetary policy and tax reform providing further incentive to investment help to reconcile full employment and a "tighter" budget policy? What will be the trends of Federal and State and local civilian expenditures under existing programs, given the prospective growth of the population and the economy? Beyond these, what are the high-priority Government programs that might be adopted?

Personally I think it is important to avoid a recurrence of "fiscal drag" on the economy. But tax reduction may not always be the only way to do that, and other ways may be preferable for social and economic progress.

Statement by Marco D. Vestich, Research Associate, United Steelworkers of America, Pittsburgh, Pa.

Initially, we must keep in mind that the foremost economic problem currently facing our society is increasing unemployment, underemployment, and poverty in the midst of abundance and prosperity. Approximately 4 million people are out of work, and about 20 percent of the families in the United States receive annual incomes of $3,000 or less.

There is every indication that unemployment and underemployment will remain America's No. 1 economic problem in the next decade. Since the low point of the 1961 recession, productivity has risen sharply resulting in lower production costs and higher profit margins, while no major reduction was achieved in the level of unemployment. With both productivity and the labor force rising rapidly, substantial increases in demand for goods and services will have to take place in order to create employment opportunities for both those currently unemployed and the new entrants into the labor market. The trend of the recent past will not change unless substantial changes are made in the current fiscal and monetary policies of our Government.

Fiscal policy can be a powerful tool for achieving and maintaining full employment and maximum use of plants and machines. Unfortunately, the Federal budget's actual operations have become a braking force on the economy's forward progress. Since the early 1950's the emphasis on a balanced budget has slowed down needed increases in Government investment for the improved public services required by a rapidly growing urban population. It has also dampened down necessary increases in sales, production, and employment, while the economy's ability to produce more goods and services has continued to grow rapidly. Dr. Arthur F. Burns, Chairman of the Council of Economic Advisers during the Eisenhower administration, pointed out that the upturn from the 1958 recession was cut short by a sharp swing of Federal fiscal operations from deficit to surplus. We are now nearing the end of 1964. The economy is still operating at a rate far below capacity, and about 5 percent of the labor force still remains unemployed. How can future Federal fiscal operations contribute to the economy's forward advance toward full employment?

The type of fiscal policy we must seek is one that will provide for a continuous balance between effective demand and the economy's increasing ability to produce a growing volume of goods and services.

This goal can be achieved by (1) a reform of the tax structure and (2) a substantial rise in Federal expenditures.

Congress has already taken a step in the right direction, with the passage of the tax reductions of 1964. However, much is yet to be desired. Too much of the recent revision was in favor of corporations and of persons in high income brackets which, in effect, will induce savings at a time when the savings function is no problem. What we need is a redistribution of the taxload, with most of the benefits concentrated among the low- and middle-income taxpayers. Low- and middle-income families spend all or almost all of their incomes. Any additional income would be spent rapidly, resulting in increases in sales which, in turn, would be accompanied by rising employment, profits, and investment. As employment, profits, and personal incomes increase, additional tax revenues would be generated.

Furthermore, special tax treatment, such as favoritism on capital gains, interest from State and local bonds, the tax splitting device, family partnership, and excessive depletion allowances for oil, natural gas, and other extraction items should be ended. Additional revenues from the closing of such loopholes could be offset by general reductions of tax rates or by increased Federal spending.

The suggested tax reforms should be accompanied by monetary policy that encourages expansion. The Federal Reserve Act should be amended to provide for the coordination of the Federal Reserve with other Government economic and credit agencies to help achieve the economic goals of the Employment Act of 1946. The autonomous nature of the Federal Reserve Board has resulted in actions that were in direct conflict with those of other Government economic agencies. It may be pointed out that, before congressional debate on the recent tax cut had ended, the Federal Reserve was considering tightening credit to slow the economy, when it should have been thinking in terms of lowering interest rates—especially on long-term loans—to create an environment conducive to economic expansion.

In addition to revision of the tax structure and suggested reforms in monetary policy, an increase in Federal outlays should be undertaken. The direction of these expenditures should be geared to the needs of our economy. Emphasis should be given to projects that fulfill long-range social economic objectives as well as shortrun immediate needs. For example, since our No. 1 economic problem is unemployment, the American economy must create over 4 million new jobs a year during the remainder of this decade in order to put all Americans to work and keep them there. A major need is a vast outlay for job-creating public works. Emphasis should be put on those projects which have the greatest employment effect as well as the greatest amount of social benefit. The unmet public service needs of the American people: Educational facilities, health, recreation, mass transportation, slum clearance and urban renewal, conservation and community facilities of every kind are examples of the types of projects that should be given top priority. Projects of the type listed not only bring maximum social benefits, but also require a cross section of product inputs, which in turn generate income and stimulate activity throughout the private sector of the economy. This does not include the multiplier effects of the consumption expenditures of those immediately employed at such projects.

In addition, studies should be conducted and careful consideration should be given to improve existing manpower utilization policies. The AFL-CIO has previously suggested that a rational manpower policy will require—

> A better financed and greatly strengthened public employment service—one that will penetrate the labor market more deeply in order to perform more effective service in counseling, training, and placement, and one with a national orientation in order to cope effectively with our national needs.

Expanded training activities, including increased training allowances for unemployed workers, increased opportunities and incentives for on-the-job training programs to help upgrade workers already employed.

Improvements in unemployment compensation benefit programs—both in the amounts paid and the duration of time over which they are paid—with Federal legislation which will compel adherence by the States to improved minimum national standards.

Full relocation allowances for unemployed workers and their families in order to enable the workers, if they so desire, to move to obtain employment.

Continued area redevelopment assistance to areas of high unemployment as part of a general program of economic expansion which recognizes that no area can be economically healthy until the whole Nation is economically healthy.

Certainly, unemployment and poverty in the midst of plenty will continue to be major problems of the next decade. The Federal Government can do much to alleviate poverty. The recommendations which come from your subcommittee can have a greater bearing on the future of our economy. We urge strong and forthright policy recommendations by the subcommittee.

STATEMENT BY HENRY C. WALLICH, PROFESSOR OF ECONOMICS, YALE UNIVERSITY, NEW HAVEN, CONN.

1. FUTURE ECONOMIC CONSEQUENCES OF PRESENT TRENDS IN FEDERAL REVENUES AND EXPENDITURES

There are a great many things that the Federal Government could usefully do with its rapidly rising revenues. Nevertheless, many of these programs encounter strong political resistance. In my judgment this resistance is not so much to the expenditure of the money involved, but to the accretion of Federal power. It seems to me that a reasonable compromise could be achieved between those who support the substance of the programs and those who are concerned with limiting Federal power. The compromise would imply the use of Federal money but with maximum decentralization of decisionmaking in its expenditure. From a research standpoint, this means seeking out the institutional arrangements that would make this possible. Dr. Heller's proposal for free grants to the States is one such device. A medicare program requiring tax contributions but offering a refund to people who prove that they take out private insurance is another. Educational grants to students individually, and to colleges on a basis free from strings, is a third. No doubt similar devices could be developed in other program areas.

2. APPLICABILITY OF FULL EMPLOYMENT BUDGET ANALYSIS TO POLICY DETERMINATION

On the subject of the full employment surplus Dr. Heller and I had an exchange of letters with Congressman Curtis which were printed in the Congressional Record, and of which I am attaching a copy. My principal points are that the full employment surplus is not a very precise quantity, even at a given rate of unemployment such as 4 percent, and that, furthermore, it fails to describe fully the expansive power of a budget, because the absolute magnitude of the budget also counts in this respect. A somewhat larger budget balanced at full employment is an expansionary as a smaller one with a full employment deficit, for example. Nevertheless, the full employment surplus is a useful device for many purposes.

These purposes could be expanded by analyzing other important features of the economy in terms of their full employment levels. What is the full employment growth rate? Rough estimates I have made lead me to think that since the beginning of 1961, our growth rate at a constant unemployment rate has been little better than 3.5 percent. As we approach full employment, the fuller use of plant and equipment capacity would probably produce higher rates of investment and hence of constant unemployment growth. Nevertheless the difference might not be great, and that certainly is cause for concern.

What is the full employment balance-of-payments deficit? This is not easy to compute, since the balance-of-payments deficit depends also on what is happening abroad. Nevertheless, the current account surplus or deficit, excluding capital movements, could probably be estimated.

What is the full employment rate of price increase? Our 4-percent interim full employment goal has been set on the assumption that it is noninflationary. Nevertheless, consumer prices have risen despite higher rates of unemployment. With unemployment still not consistently below 5 percent, price and wage pressures are now accelerating. If the 4-percent target should seem to produce an intolerable rate of price increase, we would either have to improve our instruments for conducting an incomes policy, or resign ourselves to a higher rate of unemployment.

3. ANALYSES OF THE IMPACT OF PAST POLICY DECISIONS

Frequently, a decision seeks to find the best balance between several unpleasant alternatives. Often the outcome shows it to have been more successful in avoiding one evil rather than another. The critics then will tend to overlook the threat that was avoided, and to hold against the policymakers of the past their lack of success in dealing with the evil that did materialize.

Recent analyses made of Federal Reserve policy during the 1930's illustrate this point. The Federal Reserve is blamed for failing to restore full employment during the 1930's. Whatever mistakes the Fed made, it must be recognized that avoidance of heavy capital outflows and creation of excessive inflationary fuel were legitimate fears which today tend to be overlooked because these threats were more effectively guarded against than continued unemployment. A similar situation prevailed during 1958–60. Unemployment, inflation, and the threat to the dollar all had to be watched by policymakers. The fact that inflation and dollar devaluation were guarded against more effectively than unemployment may show that the policymakers failed to arrive at a good balance of decisions. But these dangers must not be overlooked in analyzing the failure adequately to deal with unemployment. If future policy studies by the committee can drive home this point, they will make a valuable contribution.

4. TAX STRUCTURE

Current eagerness to remove excise taxes strikes me as not well advised. It is true that these taxes are discriminatory and call for reform. But this reform should be, in my judgment, not abolition but modification of the excise tax principle pointing in the direction of a value-added tax. Since this is a familiar proposition, there is no need for detailed comment.

(The letters mentioned in section 2 of this statement follow:)

[From the Congressional Record, July 3, 1964]

FEBRUARY 11, 1964.

DR. WALTER W. HELLER,
Chairman, Council of Economic Advisers,
Executive Office of the President, Washington, D.C.

DEAR DR. HELLER: In his economic report the President says that the administration's program will provide a greater net stimulus to the economy this year than in any other peacetime year in history. I would appreciate it if you would set forth the reasoning and the figures upon which this statement is based.

I am also curious about whether you consider the administration's expenditure policy this year stimulative or not. In the Council's economic report you state that "The tax and expenditure program will give a bigger fiscal stimulus in calendar 1964 than in any of the past 3 years." However, in reply to questions which I submitted to you at the Joint Economic Committee's annual hearings you say "the spending side of the Federal budget can hardly be considered stimulative in 1964."

Because of the importance of a correct understanding of the concept of the full employment surplus, I would also appreciate your setting down in detail the figures upon which the estimates of the full employment surplus for 1962, 1963, and 1964 are based.

With best wishes and many thanks for your cooperation.

Sincerely yours,

THOMAS B. CURTIS.

COUNCIL OF ECONOMIC ADVISERS,
Washington, D.C., April 27, 1964.

Hon. THOMAS B. CURTIS,
House of Representatives,
Washington, D.C.

DEAR MR. CURTIS: I am pleased to reply to your letter of February 11, 1964, requesting us to set forth the reasoning and figures on which the President based his statement that the 1964 fiscal program will provide a greater net stimulus than in any previous peacetime year.

We delayed our reply because, at the time of receipt of your request, there was underway a full-scale interagency review of the full-employment budget estimates on which the President's statement was based. This review was expected to produce new and more refined estimates of the full-employment budget. This work is now completed, and I am pleased to report that the new estimates do not differ significantly from the previous ones.

As you know, the Council holds that the full-employment budget on a national income accounts basis provides the best single summary of the impact of the Federal fiscal system on our national product and income. This expenditures side of this budget is an estimate of what, under conditions of full employment, would be the total of:

(*a*) Federal purchases of goods and services, and

(*b*) Federal transfer payments, interests, subsidies, and grants-in-aid—all of which add to the purchasing power of households, businesses, and State and local governments.

The revenue figures show the withdrawal of potential private purchasing power that would result from Federal tax collcetions at full employment.

Since the full-employment budget is estimated at a constant 4-percent unemployment rate, it shows the impact of the Federal fiscal program independently of the strength or weakness of the forces (other than Federal expenditures and taxes) affecting private demand. Since the receipts and expenditures actually realized in any year are not independent of these forces, the actual budget outcome does not provide an adequate measure of the budget impact taken by itself. The basis for this analysis is set forth more fully in the 1962 and 1964 Economic Reports.

Under the Employment Act of 1946, responsible fiscal policy must—so far as practicable, and consistent with the strengthening of free enterprise—respond to the strength or weakness of private demand in such a way as to maintain "maximum employment" and "maximum production," in a context of reasonable price stability (needed to maintain "maximum purchasing power"). With existing labor-market conditions and with responsible price and wage decision-making, we believe that our interim objective, under this criterion, should be to bring the unemployment rate down to no more than 4 percent. (As habits of responsible wage and price making become entrenched and as structural imperfections in the labor market are reduced, we should find it possible to bring unemployment below this level.)

The long-standing problem of excessive unemployment that had persisted since 1957 clearly demonstrated the need for a Federal fiscal program considerably more stimulating than was in effect prior to 1964.

Making the Federal budget more stimulating requires either a substantial year-to-year increase in expenditures or reduction in tax rates, simply because of the large built-in revenues—as our potential gross national product grows.

If the constant-dollar potential GNP grows by 3½ percent a year, and the GNP deflator rises about 1½ percent a year, then the potential GNP in current prices will rise at about 5 percent a year. We estimate full-employment revenues on a national income accounts basis to have been $122.4 billion for 1963. Since, with our present tax system, these revenues grow only slightly more than in proportion to GNP, a 5-percent rise of GNP would yield a rise of approximately $6 billion in Federal tax collections.

In order to avoid an increasingly restrictive budget under the 1963 tax laws, therefore, Federal expenditures—on national income account, including trust account outlays—would also have had to rise by about $6 billion. As a matter of economic arithmetic—not value judgment—this much expenditure rise would have been needed just to avoid an increasing fiscal restraint in a growing economy. Taken by itself, any smaller expenditure growth would contribute to a growing full-employment surplus. However, with a reduction in tax schedules, it becomes possible to have a smaller expenditure rise (or even a decline), and still have the budget move toward a more stimulating position. This is what is being done by the Congress and administration in the 1964 program.

The two tables which follow set forth the movements in the full-employment budget over the past few years and the projected movements in 1964.

Table 1 shows estimated full-employment Federal revenues, expenditures, and surplus or deficit—estimated on the basis of the tax-rate structure that was in effect in 1960–61, on the actual contribution rate for the OASDI program, and on the contribution rate to the unemployment compensation system that would have prevailed under full-employment conditions.

Table 2 differs from table 1 in that the revenue estimates reflect the effects of the 1962 Revenue Act, of the revised 1962 depreciation guidelines, and of the 1964 Revenue Act.

Since these numbers represent estimates of what would have happened if the economy had been operating at a 4-percent unemployment rate rather than the actual higher unemployment rates, the figures contain some element of conjecture. This is necessarily even more true for the 1964 estimates. Hence honest disagreement could arise over these numbers. However, we are confident that the margin for dispute would be small.

As these figures show, the budget became somewhat less restrictive in 1961 and 1962, somewhat more restrictive in 1963. The 1964 program involves a large shift; namely, $8 billion, in the direction of fiscal stimulus. This is above the combined stimulus of the preceding 3 years and exceeds the stimulus of any other peacetime year.

I hope that this exposition and the accompanying tables will serve to answer your inquiry. If we can be of further help, please call on us.

Sincerely,

WALTER W. HELLER, *Chairman.*

TABLE 1.—*Full employment revenues, expenditures, and surplus or deficit under 1960–61 revenue system* [1]

[In billions of dollars]

Calendar year	Revenues	Expenditures	Surplus or deficit (−)	Net fiscal stimulus [2]
1960	104.4	92.0	12.4	
1961	110.2	100.6	9.6	+2.8
1962	116.5	108.7	7.8	+1.8
1963	125.0	115.2	9.8	−2.0
1964	131.2	119.2	12.0	−2.2

[1] Revenues estimated on the basis of the 1960–61 tax-rate structure, the actual contribution rate for the OASDI program, and the rate of contributions to the unemployment compensation system that was estimated would prevail under full-employment conditions.

[2] Reduction of surplus from preceding year.

TABLE 2.—*Full employment revenues, expenditures, and surplus or deficit reflecting 1962 tax and 1964 changes*[1]

[In billions of dollars]

Calendar year	Revenues	Expenditures	Surplus or deficit (−)	Net fiscal stimulus [2]
1960	104.4	92.0	12.4	
1961	110.2	100.6	9.6	+2.8
1962	113.6	108.7	4.9	+4.7
1963	122.4	115.2	7.2	−2.3
1964	118.7	119.2	−.5	+7.7

[1] Revenue estimates reflect the effects of the 1962 Revenue Act, the 1962 new depreciation guidelines, and the 1964 Revenue Act.
[2] Reduction of surplus from preceding year.

JUNE 25, 1964.

Hon. THOMAS B. CURTIS,
House of Representatives,
Washington, D.C.

DEAR TOM: I have read with great interest your correspondence with Dr. Heller bearing on the full employment surplus and the estimates related to it. In responding to your request for comments, I would like to make the following points:

1. The concept of the full employment surplus as a guide to fiscal policy has been in use for some time. One such use has been that made by the Committee for Economic Development in its policy statements on the budget, "Taxes and the Budget: A Program for Prosperity in a Free Economy" (New York, November 1947), which was analyzed in an article by Dr. Heller in the American Economic Review of September 1957. The statistical precision given to the full employment surplus by the Council of Economic Advisers, I believe, represents a new step in economic analysis.

This statistical precision nevertheless brings into focus various weaknesses of the concept. One weakness derives from the uncertainty of what constitutes "full employment," which the CEA today, as well as the CED in 1947, place at 4 percent unemployment. This has also been the target concept of the Eisenhower administration. We do not know, however, how far unemployment can be reduced without inflationary consequences. Recently, Senator Clark's subcommittee came out in favor of a 3-percent standard. Personally I fear that, with unemployment of all but teenagers already close to 4 percent, and teenage unemployment at about 15 percent, constituting about one-fourth of the total, the noninflationary definition of full employment will have to be well above 4 percent, until a solution is found to the recent extraordinary bulge in teenage unemployment.

A difference of 1 percent unemployment, on the Council's calculation, means a difference of about 3 percent of GNP and a slightly larger percentage of Government revenues. Thus a change of 1 percent in the full employment standard, one way or the other, may mean a difference of 4 to 5 million in the full employment surplus.

2. The full employment surplus depends not only on the level of national income, given the expenditures of the Government, but also on the share of corporate profits in that income. Usually the share of profits rises sharply as unemployment falls from high levels. The Council's estimates have involved a 10-percent ratio of corporate profits to GNP at full employment. While this relationship has prevailed at certain times in the past, it has not recently been tested owing to our failure to reach full employment. At the present level of GNP and corporate profits, we are still well below 10 percent, and nevertheless it has been argued by some on the labor side that profits are already unfairly high. If in future periods of full employment the share of corporate profits, with their high tax yield, should be lower than in the past, the full employment surplus will also be lower. This uncertainty is compounded by recent changes in depreciation techniques which have obfuscated the concept of corporate profits.

3. Dr. Heller in his 1957 article points out some further factors that interfere with a precise calculation of the full employment surplus:

(1) The Mills plan for speeding up corporate income tax payments, a new version of which was introduced with the recent tax cut. (But this does not affect the income and product account surplus.)

(2) Transfers of public expenditures from the budget into the banking system.

(3) Yearend manipulations to retard processing of taxpayments and accelerating present payments.

(4) The Federal credit programs.

4. The full employment surplus by itself is not an adequate way of describing the stimulating or restraining character of a given Federal budget. The absolute size of the budget also counts. That is to say, a full employment surplus of 5 billion when revenues are 95 and expenditures 90 is not the same thing as when revenues are 105 and expenditures 100. This is attributable to what economists refer to as the "balanced budget multiplier." In simplest terms, the "balanced budget multiplier" proposition says that because the Government does not, like the consumer, save a fraction of every marginal dollar of receipts, savings in the economy are not increased when the Government raises its receipts and its expenditures by the same amount. Assuming the presence of unemployed resources, it then follows that for a given level of private saving and investment, GNP will tend to be increased by the amount of the budget increase.

The Council of Economic Advisers takes account of the balanced budget multiplier by describing the full employment surplus as the "single most important" measure of the impact of the budget. But in order fully to describe the impact of a given budget, not only its full employment surplus but also its absolute magnitude would have to be considered. Very roughly speaking, an increase in both revenues and expenditures by some particular amount tends to be equivalent, in stimulating effect, to a reduction in the full employment surplus of one-half that amount. For example, if at any given moment Government expenditures were to be raised by $1 billion and matched by an increase in tax rates to produce $1 billion in revenues, this would have about the same effect upon the level of GNP as would a $0.5 billion increase in expenditures without an increase in tax rates.

Thus, budget A that has a larger full employment surplus than budget B may nevertheless be more expansionary if the absolute levels of revenues and expenditures are also higher than in budget B. Failure to emphasize this, and stressing only the full employment surplus, can mislead as regards the true impact of the budget. It also draws away attention from the magnitude of the budget which is important also for other reasons. The magnitude of the budget should, of course, always be viewed in relation to the level of GNP.

5. The use of the full employment surplus as a means of defining the stimulating or restraining character of a budget also abstracts from the monetary consequences of surpluses and deficits. Surpluses permit debt repayment, deficits must be financed. Following the logic of the full employment surplus, we are compelled to say that the budget with a larger full employment surplus is always more restraining than a budget with a smaller one. For instance, if budget A has a full employment surplus of $5 billion, but because of recession is currently producing a deficit of $10 billion, it is nevertheless more restraining than budget B that has a full employment surplus of $3 billion and, owing to better business conditions, is currently producing a surplus of $2 billion. Yet the financing of the deficit under budget A may have very stimulating effects, if bank credit is used. Debt repayment under budget B may contract the money supply, if bank held debt is repaid. The overall effects—income plus monetary—of deficit budget A may therefore be more expansionary than those of surplus budget B, despite their different full employment surpluses.

6. The distinction between the income and monetary effects of a budget would be appropriate, although practically difficult, if assurance could be had that in practice the Federal Reserve would be quite free to handle the monetary side. This, however, is uncertain. The politics as well as the economics of the full employment surplus tend to obscure the inflationary dangers of deficits with inadequately controlled financing. The financial aspects of deficits tend to be ignored. We are led to think in terms of surpluses that may be a statistical illusion.

7. Exclusive stress upon the concept of full employment surplus is likely further to confuse the discussion of fiscal policy in this country. A great deal of unreasoning prejudice exists against the use of deficits when they are appropriate, just as there exists, in other quarters, a lack of concern about them when they are not appropriate. If the full employment surplus is used as the principal guide, we shall at times find ourselves in the position of having to argue that a particular deficit is restraining and that a particular surplus is expansionary. It

is more plausible to say that a particular deficit is not sufficiently expansionary or a particular surplus not restrictive enough. While the distinction is one of semantics, it also has an influence on people and on votes.

8. To summarize my remarks, I regard the full employment surplus as a valuable concept, but as statistically uncertain and as a very much less than adequate description of the effects of a particular budget. It would be regrettable if its elegance and seeming simplicity should tempt us to make more use of it than it can give.

Sincerely yours,

H. C. WALLICH.

Statement by Melvin I. White, Professor of Economics, Brooklyn College, Brooklyn, N. Y.

1. Despite the lively interest being shown these days in alternatives to the individual income tax, I do not think the relative importance of this tax should be diminished in the revenue structure. The argument that such substitution would promote economic growth contains, I think, logical flaws and lacks necessary empirical substantiation. I can indicate my reasoning briefly:

First, with regard to investment incentives, it is clearly the upper bracket rates which are relevant, but the revenue yielded by these rates is relatively small, so that if they were substantially reduced (to a maximum of 50 percent, for example) the revenue loss would not seriously modify the relative importance of the income tax.

With regard to effort incentives, the relevant range of rates may reach further down the income scale. But whatever the income level, the incentive aspect concerns the incremental or marginal rate. Were the base broadening reforms which have long been advocated by tax economists put into effect, marginal rates throughout the tax structure could be reduced without changing the overall yield, and without altering the basic progressivity of the tax, since this is a function of the average effective rates (ratio of yield to income) in each income class, and these rates could remain substantially unchanged. In general, economic incentives depend on the marginal rates (if they are influenced by taxes at all) while equity depends on the average rates.

With regard to savings, it probably is true that shifting from raising a given amount of revenue by progressive income taxes to, say, sales taxation (in the form in which it would be likely to be imposed) would increase total savings. But the restriction of raising a given amount of revenue is really not applicable for this comparison. Additional community savings—i.e., reduced real consumption—can be achieved by maintaining a higher level of revenue from the existing tax structure and a lower budget deficit, than otherwise.

However, there is good reason to doubt that the impact of taxation on the overall inducement to save, invest, and work is of great significance for economic growth. Certainly the work in recent years on the sources of economic growth leaves open the possibility that the overwhelmingly important factor is technical advance, the product of invention and innovation. The connection between the tax system and these growth variables is uncertain and insufficiently explored, and cannot be the basis for policy at the present time.

There is not doubt in my mind, however, about the superior merits of individual income taxation from an equity point of view. I think we can take long strides toward improving the equity of the income tax—strides that were not taken in the Revenue Reduction Act of 1964—and at the same time do nothing that is demonstrably inconsistent with efficiency and longrun growth. And we may do some things which actually promote them.

I would therefore place base broadening and improvement of the individual income tax as the most important objective for revision of the tax structure.

2. As a corollary of the above, changes should be made in the corporate income tax. Whether this tax is assumed to be shifted forward in the form of higher prices, or to remain on corporate profits, it discriminates against the corporate form of doing business. I see no justification in equity or economic efficiency for such discrimination. While a substitution of the frequently proposed value-added tax would be neutralizing, I think this approach is inferior to integrating the corporate tax into the board-based individual income tax—the latter to include proper treatment of capital gains. The most hopeful method of doing this is probably to turn the corporate tax into an approximate withholding tax on profits. (The dividend component only if capital gains are fully taxed to the individual.)

The possible balance-of-payments advantages of a value-added form of tax in permitting export credit adjustments do not seem sufficient—or sufficiently certain—to change my preference for the withholding approach to the corporate tax.

3. In the field of sales and excises, my view is that the only legitimate bases for such taxation are sumptuary or benefit, and I am not so sure about the former. The sumptuary taxes are, of course, traditionally illustrated by liquor and tobacco taxes; benefit excises by the automotive taxes. All others should go, the sooner the better. Quite adequate priority lists have been set forth in the Ways and Means compendium of June 15, 16, 1964.

4. I tend to take an optimistic view of our technical capacity to control instability through fiscal policy. The major obstacle to success in stabilization policy is not lack of sufficient knowledge, but lack of a governmental setup which permits the knowledge to be effectively utilized. A most important lack at present is the means for rapid contracyclical adjustment of the basic (first bracket) rate of the individual income tax. Whether by formula relating the tax rate to an index of economic conditions, or by granting limited discretionary authority to the President, something should be done to make rapid tax rate adjustments available as a stabilization device.

I do not mean to imply, however, that our knowledge about the efficacy of fiscal policy cannot be or should not be improved. In particular the construction of econometric models, in which the fiscal system appears as an explicit variable, is a continuing source of relevant new knowledge. The incorporation into such models of information obtainable from tax returns via the recently created magnetic tape tax return file undoubtedly will produce advances in knowledge about all kinds of fiscal effects. Nevertheless, the knowledge we have now is adequate to provide us with better policy than we pursue.

5. In two senses, I look forward to continued growth in Government civil expenditures and revenues: I believe such growth will take place; and I believe it should take place. I do not say the latter because of any concern for maintaining full employment. That could be done by adjustments on the revenue side. Rather it is because I think a larger income, a more rapidly growing income, and a more satisfying income will be associated with full employment as a result of expansion of Government expenditures. I look for expansion in the traditional

functions of Government (education, public health, hospital care, transport, and recreation) as well as the newer areas of urban renewal, basic research, conservation and utilization of natural resources.

There is implied in my expectations—and hopes—a considerable expansion in the functions traditionally performed by State and local governments. If the financial resources of these governmental units are not equally expansible, then the volume of Federal financing, or the scope of Federal functions, or both, must be enlarged. But in addition to the financial issue, I think we must expect a trend toward greater Federal involvement in the traditional functions of local government. In part this is the effect of increased population density, mobility, and spatial integration that has been taking place: more and more of what is done in one locality is of concern to another and this concern is naturally expressed through the National Government.

Although I accept a trend toward centralization as inevitable and beneficial, I nevertheless have a bias in favor of limiting it. I do not at present have firm views as to how to accomplish such limitation. However, on the financial side of the issue, I favor the cultivation of elastic sources of revenue for local governments, particularly income taxation (I see no merit in the separation of sources doctrine) and I would be interested in the possibilities of greater use of block grants.

Statement by James H. Wishart, Research Director, Amalgamated Meat Cutters & Butcher Workmen, Chicago, Ill.

Economic forecasters who some months ago projected a $40 billion increase in gross national product during 1964 in association with a $11.5 billion cut in Federal taxes appear to have been almost exactly on target. Fiscal policy in this instance has worked with substantial precision to achieve predetermined results.

This 1964 experience suggests both the possibilities and responsibilities of Federal fiscal policy for the future. The possibility of its use to reach a desired rate of growth has been demonstrated; also demonstrated conversely is the point of responsibility for any lag in growth rates and any rise in the level of unemployment. In the future, it may well be argued that the continuance of unemployment and poverty is possible only as a matter of deliberate choice and accommodation. Certainly the strong and flexible tool of fiscal policy is one which must be wielded responsibly by the Federal Government in line with its commitment to full employment and victory in the war against poverty. That these are not in fact current goals, is suggested by the outlook for 1965 accepted by fiscal and monetary authorities.

Forecasters, by something approaching total consensus, anticipate a slower rate of growth in 1965 than in 1964. Most projections fall measurably below the 4.2-percent average annual rate which has marked the rise of the economy since 1960. In relation to an expanding labor force such a lower rate of growth will mean an actual rise in joblessness in 1965. In 1964 only a small drop in unemployment rates came from a rise of more than 5 percent in real GNP. Next year GNP is expected to rise about 3.5 percent and the number of young people reaching the age of 18 will be roughly 1 million more than in the previous year. Such labor force growth must compel acceleration rather than retardation in the whole pace of the Nation's economy if unemployment is not to mount above its present dangerous levels. Substantial expansion must come if there is to be any hope for reducing the presently intolerable burden of economic and social waste caused by unemployment.

Along with other tools of government, fiscal policy must be the servant of a total program aimed at the full use of massively expanding human and technical resources. The alternative is one of economic and social dislocation, accelerated by the application of surging new technologies.

For such purposes something more than an increase in gross dollar spending is needed. Statistical aggregates may not necessarily meet critical areas of human or social need. For example, a sudden spurt in the production of passenger cars could create, along with some important economic stimuli, a range of new and dangerous social costs more than offsetting such gain. The appropriation of more dollars for research and development will in itself have little effect on the pace of scientific or technical progress. For the bottlenecks to such progress are not financial but human. The shortages are in highly trained manpower. The need, therefore, is for spending directed toward a long-term basic improvement in the Nation's whole educational system.

Expansion of the luxury and service sectors of the economy by themselves would tend to leave tens of millions in poverty and dampen the demand for labor in basic commodity producing industries, where there is an employment potential for unskilled workers.

Although a logical case may be made for the reduction of excise taxes, there is ground for grave doubt that the ensuing loss in Federal revenue would be offset by an increase in effective demand from the average family. Much of such tax reduction would slide off as price increases for business rather than gains for consumers.

Beyond argument, State and local governments, hamstrung by artificial jurisdictions and archaic tax structures, need Federal assistance in amounts going beyond anything before provided. Such real and urgent need cannot, however, justify handing funds over to States without any Federal control and programing of basic local patterns. Despite the assertions of one recent presidential candidate to the contrary, the current complex of metropolitan area problems, creating something close to strangulation, cannot find solution strictly by local initiative. Federal standards and a measure of Federal control are essential if Federal aid to the States is not to become simply a subsidy for local anarchy and waste.

Fiscal policy must, in sum, be aimed at two main objectives: (1) a dramatic expansion of total demand to allow for the attainment and continuation of full employment and (2) a flexible and wise allocation of growth stimulants to areas of the most urgent economic and social need.

These are critical national goals. They must be the final yardstick against which all issues of policy are measured. These key conceptions point to certain general conclusions concerning a number of problems:

1. There must be strong rejection for any policy which would seek solution for the essentially technical problems of international monetary relations through deliberately deflating or retarding the U.S. domestic economy. Solution to these problems must and can be found without stunting the total economy through concern with an outflow of dollars amounting to less than 0.3 percent of current GNP. In this period of substantial economic sophistication, national immolations either on a cross of gold or a cross of Lorraine make no sense.

2. The experience of 1964, with a tax cut carried through in the face of a Federal deficit, suggests that the shibboleth of the "balanced budget" carries declining weight. Concessions made to this lingering concept in terms of a $100 billion ceiling on Federal spending may have short-run political viability, but they cannot be made an eternal law of government.

3. The essentially regressive impact of changes in the tax structure over recent years must be realistically appraised. The increasing weight of generally regressive State and local taxation in the overall burden carried by individuals, the massive tax concessions given to business and upper bracket income, and the increasing gouge of taxa-

tion on families at or below the poverty level are developments directly affecting the basic equity of income distribution throughout the economy. Action to redress such imbalance is essential to national progress. Many facts suggest that the widely publicized trend toward income equalization is largely illusory. Certainly a society of poverty continues to coexist with one of affluence in this country. Not only moral imperatives but the requirements of healthy economic progress—expanding markets and purchasing power—demand action in this area.

4. Conceding that a high rate of private investment is associated with an expanding economy, it must be recognized that the effective stimulant to such investment is the assurance of steadily increasing demand for the end products of farms and industries. The effectiveness of investment credits or outright cuts in rates of corporate taxation are of doubtful efficacy.

5. Official attitudes toward the economic aspirations of wage and salary earners must go beyond a simple management correlation of wage gains with "cost increases." Although academic research in the field has been inadequate, it is significant that the economic cataclysm of 1929 was preceded by years of absolute stabilization or declines in the money wages of workers and declines in unit labor costs. It may be that too many competent analysts have been myopically concerned with the purported impact of wages on price levels excluding consideration for the accelerator effect of wage progress on the total economy.

Statement by Theodore O. Yntema, Chairman, Finance Committee, Ford Motor Co., Dearborn, Mich.

The questions cited in Congresswoman Griffiths' letter are in themselves an excellent definition of a program of work appropriate for the committee. The following list should be considered as an appendage to and extension of these questions.

I. FISCAL POLICY FOR STABILITY AND GROWTH

1. Concepts of the budget useful for fiscal policy.
2. The balance in the budget (receipts minus expenditures) appropriate for growth and stability.
3. Changes in the budget balance making for economic stability, and how these changes can be achieved: automatic stabilizers and ad hoc actions.
4. Conditions in the economy limiting the possible use of fiscal policy: Conditions making for cost-price inflation; structural obstacles of all kinds to employment, especially of young and less competent workers; balance of international payments and the international financial mechanism for their adjustment.
5. Federal expenditures to facilitate economic growth that will produce benefits in execess of costs and that are not properly financed in full by user charges.
6. Effects of reducing the level of expenditures and taxation on economic growth.
7. Interrelations of fiscal and monetary policies.

II. LEVEL AND STRUCTURE OF TAXATION

1. Examination of each tax, and of possible modification in it, in regard to its impact on incentives for risk taking, expansion of employment, innovation, and economic growth.
2. Examination of each tax to determine its incidence and differential burden on various groups in the economy.
3. Special study of the effects of the corporate profits tax, of discriminatory excises versus a broadly based excise (perhaps on value added), and of high marginal rates in the individual income tax.
4. An attempt to appraise, in terms of all considerations, the optimum level of total Federal taxation.
5. Relations of Federal, State, and local fiscal problems.

III. FEDERAL EXPENDITURES

1. Appraisal of the value to the country at large of various Federal expenditure programs and possible modifications in them.
2. Criteria for the appraisal suggested in III-1, especially criteria for judging the desirability of Federal subsidies and of grants-in-aid to special localities for activities or groups.

PART B

STATEMENTS SUBMITTED IN REPLY TO MRS. GRIFFITHS' LETTER OF OCTOBER 1964

The American Farm Bureau Federation: Statement by W. E. Hamilton, Director of Research, and Resolution of Monetary, Spending, and Tax Policies

We appreciate the opportunity to submit suggestions for consideration in connection with the formation of a hearing agenda for the Subcommittee on Fiscal Policy. Our suggestions are as follows:

(1) What are the implications of present trends in Federal revenues and expenditures for—

(a) Our efforts to avoid inflation; and

(b) Our efforts to solve the balance-of-payments problem?

(2) Do the rising needs of the States for revenue indicate a need for Federal Government to—

(a) Withdraw from certain areas of taxation, or

(b) Develop some type of program for sharing income tax revenues with the States?

(3) Is there a need for a uniform Federal policy of making payments in lieu of taxes to local government units where—

(a) Federal acquisition has resulted in the removal of private property from the tax roles, or

(b) Federal projects have materially increased the costs of providing local government services?

The following resolution was adopted in December 1964:

Resolution on Monetary, Spending, and Tax Policies

Inflation is a serious threat to our private enterprise system and individual freedom. The American dollar has lost more than half the purchasing power it had in 1940. This has caused serious hardship to many citizens with fixed incomes, created a cost-price squeeze for farmers and ranchers, and had an adverse effect on our entire domestic economy. Inflation also threatens the stability of the dollar in foreign exchange.

We reaffirm our belief in the importance of measures to bring about a more stable general price level as a means of providing a favorable climate for economic growth and a rising standard of living. This is essential if we are to avoid a far-reaching expansion of Government controls over individual decisions and actions.

We continue to oppose direct price and wage controls.

Government policies which affect the supply of money and credit should promote a relatively stable general price level together with high employment and rising productivity. Government also has a responsibility to conduct its affairs so as to inspire confidence that extremes of inflation and deflation will be avoided.

The Federal Reserve System should help to stabilize the price level by relating its policies to the country's needs for money and credit rather than to other considerations. It should restrain the expansion of bank credit in inflationary periods and make it easier for the banks to extend credit if deflation threatens. The independence of the Federal Reserve Board must be maintained.

Existing law should be amended to permit the Treasury to pay competitive interest rates on long-term Government bonds.

The policies of Government agencies which make or guarantee loans should be coordinated with overall credit policies.

The Employment Act of 1946 should be amended to make it clear beyond any doubt that it is national policy to stabilize the purchasing power of the dollar as well as to maintain a high level of employment.

GOVERNMENT SPENDING

We have had an unbalanced budget in 24 of the last 30 years. If the Federal Government continually engages in deficit spending, we cannot hope to prevent inflation. Since deficit spending is robbing our children of their heritage, we favor action to limit Federal expenditures to the amount collected in revenues in the previous fiscal year. To achieve this objective all Government agencies must exercise strict economy, eliminate duplication of effort, and promote efficient operations. In addition, Congress must take effective measures to manage and control Federal expenditures. The practice of authorizing expenditures from public debt transactions as a means of avoiding annual review by the Appropriations Committees should be discontinued.

Some Federal programs have been enacted and others have been proposed for the stated purpose of providing jobs for the unemployed.

Such programs are wasteful and ineffective. It is difficult to adjust Federal spending to rapidly changing business conditions. It is even more difficult to find sound projects that will provide work for those who are actually unemployed. Due to unavoidable timelags, increases in spending authorized to combat a recession are likely to add to inflationary pressures in the subsequent recovery period.

Emergency-type spending programs are also undesirable because they generally bypass State governments and delegate excessive discretionary authority to Federal officials.

An increase in Federal spending financed by taxes or by borrowing private savings reduces correspondingly the capacity of the private economy to provide employment opportunities. An increase in spending financed by an expansion of the money supply tends to reduce the value of private savings. Furthermore, it is likely that action to increase the supply of money available to the private economy would have a greater effect on total employment.

Decisions to spend Federal funds should be based on the merits of specific proposals and the development of such priorities as may be necessary to avoid continuing deficits.

The Federal Government can contribute most effectively to the achievement and maintenance of a high level of employment by following monetary, tax, and expenditure policies which tend to stabilize the general price level and create a favorable climate for individual incentive and private economic development.

INCOME TAXES

The continued growth of the American economy requires a sustained growth in savings and investment.

Tax policy should be designed to encourage private initiative, contribute to the stability of the general price level, and bring about an equitable distribution of the tax burden.

Plans should be developed for further reductions in income taxes within the framework of a balanced budget, as economic growth increases revenues from existing rates. Rate reductions should have priority over proposals which would substantially reduce the number of taxpayers. Rates should be reduced both for individuals and for corporations on a basis which will encourage investment for expansion of the economy as well as increased consumption.

Effective action should be taken to prevent abuses in the use of farming losses to reduce taxes on other income.

TAXATION OF CORPORATIONS AND COOPERATIVES

All corporations should be permitted a deduction for earnings distributed to stockholders as dividends and taxable in the hands of the stockholders.

The net savings and income of farm cooperatives should be subject to a single Federal income tax, to be paid either by the cooperative or the patron, as earned.

FLUCTUATING INCOMES

The law which permits operating losses to be carried forward or backward is of value to the self-employed; however, farmers can lose their labor income without establishing a basis for reducing their taxes in more profitable years. As a partial solution of this problem, we recommend that self-employed taxpayers be allowed to carry unused personal exemptions forward or backward as operating losses. We recommend that individuals and unincorporated businesses be allowed to defer depreciation whenever they are unable to benefit from taking full depreciation allowances. We also favor provisions for the averaging of fluctuating incomes. This is now permitted to a limited degree under amendments adopted in 1964.

SALES AND EXCISE TAXES

In order that the State and local governments may provide services requested by their citizens, specific areas of taxation—such as the retail sales tax field—should be reserved to State and local governments. Federal excise taxations should be limited to nonessentials and user-type taxes such as the tax on passenger transportation by air and the taxes now committed to the Federal highway trust fund. In revising the excise tax structure, first priority should be given to the elimination of taxes that affect farm production costs.

CAPITAL GAINS

Capital investment is a key factor in increasing per capita production in both industry and agriculture. The tax treatment of capital gains should encourage investment without creating tax loopholes and without unduly discouraging the sale of property. The present law results in the taxation of so-called gains which merely reflect a decline in the value of the dollar. In periods of rising prices this penalizes property owners and discourages the sale of property, including farms.

We recommend that the present minimum holding period be continued and that the rate of tax on capital gains be reduced as the length of the holding period increases.

Where a farm is taken for public use, the owner should be given an opportunity to invest the proceeds in another business with the same tax treatment as if he had reinvested in farmland.

We support the present law with respect to capital gains treatment for sales of breeding livestock.

EXEMPTIONS AND DEDUCTIONS

The laws which have resulted in the establishment of a multitude of tax-exempt foundations should be revised to prevent the misuse of such foundations for political and other noncharitable purposes.

Groups otherwise tax exempt should be required to pay property taxes on income-producing property and income taxes on income derived from unrelated business activities.

Income from all future State and local government bonds issued to finance commercial ventures normally carried on by private enterprise should be taxed as other income is taxed.

We oppose efforts to give employees a tax deduction for payments to retirement programs which provide nontaxable benefits.

The exemption from Federal estate taxes should be doubled in recognition of the reduction that has occurred in the purchasing power of the dollar since the present exemption was adopted.

Since the law permits some taxpayers to receive employer-financed fringe benefits—including hospital and medical insurance—on a tax-free basis, we recommend that other taxpayers be allowed deductions which will provide comparable tax treatment for similar items.

SELF-EMPLOYED RETIREMENT ACT

The Self-Employed Retirement Act makes it possible for farmers and other self-employed persons to obtain a portion of the tax benefits that long have been available to many employees under employer-sponsored retirement plans. In the case of farmers, the benefits of this act are severely restricted by the requirement that only 30 percent of the earnings from self-employment involving the use of capital and labor shall be included in the taxpayer's earnings base.

We urge that the law be amended to permit farmers to participate on a more equitable basis.

DEPLETION ALLOWANCES

We support continuation of the present depletion allowances for industries based on the extraction of exhaustible resources.

PAYMENTS IN LIEU OF TAXES

The Federal Government should adopt a definite and uniform policy of making payments in lieu of taxes to local units of government on (1) property removed from tax rolls by Federal acquisition, (2) tax-exempt Indian lands, and (3) Federal property used in the production of commodities or services for sale in competition with private enterprise.

The American Federation of Labor and Congress of Industrial Organizations: Statement by Nat Goldfinger, Director, Department of Research

It is now widely recognized that the Federal Government's taxing, spending, and investment policies should be geared to meeting the need to sustain full employment and maximum use of plant and equipment, as well as meeting bugetary, defense, and public-service requirements.

The Federal Government's fiscal policy is a most powerful tool of national economic policy. Through its effects on the amount of money in the private economy for consumer spending, savings, and investment—as well as the amount of funds for Federal programs—Federal fiscal policy has a powerful impact on the level of sales, production, and employment.

By adding funds to the economy's spending stream, fiscal policy can offset the unemployment-breeding slack of insufficient demand for the increasing volume of goods and services that can be produced. Or by withdrawing funds from the spending stream, when the economy is operating full blast and demand is rising rapidly, fiscal policy can counter inflationary shortages of goods, productive capacity, and manpower. However, unless fiscal policy is geared to the economy's changing realities, it can generate either unemployment or inflationary shortages.

The Federal Government's fiscal policy, however, has more than an aggregate impact on the general level of economic activities. The Government's taxing, spending, and investment policies are a factor in the distribution of income among the various groups in the population. And the specific details of Federal expenditure and investment programs have varying impacts on the level and types of employment, as well as on the different kinds of public and social services.

The major problem confronting American fiscal policy at present and in the past dozen years has been a persistent trend toward unemployment and underutilization of plant and equipment. This problem is itself rooted, to a great degree, in the fiscal policies that have been pursued, resulting in a continuing trend, during most of the past dozen years, toward oversavings in both private and Federal Government sectors.

It may be, as many economists suggest, that the general level of production and income in America is so high that the savings of private business and individuals, including insurance and pension funds, tend to be greater than effective demand for private investments in industrial and commercial building, machinery, residential construction, and inventories. Whether or not such inherent tendency exists in the American economy, however, the Government's fiscal policies, themselves, have contributed to oversavings in the private economy.

The Revenue Acts of 1954 and 1962 were designed to increase the flow of cash to corporations and wealthy families—to boost the savings of private business and individuals. The effect of these policies on the corporate sector, combined with the pricing policies of the dominant corporations in several key industries, can be seen in the fact that the high and rising cash flow to nonfinancial corporations, after payment of taxes and dividends, has been in excess of the amount of money these corporations invested in new plant and equipment in recent years.

In the 5 years, from 1959 through 1963, the cash flow of nonfinancial corporations, after taxes and dividend payments, was more than $8 billion greater than they invested in new plants and machines. Even in 1964, a year of booming capital goods investment, the corporate cash flow exceeded corporate fixed investment.

Part of these savings has gone for corporate mergers and the withdrawal of stock from the public markets. Another part has gone into investments in the industrial countries of Western Europe, England, and Japan, contributing to the balance-of-payments difficulty.

The persistence of such oversavings—siphoning funds out of the economy's productive spending stream—results in a lack of balance between actual sales and the economy's increasing ability to produce a growing volume of goods and services. Such lack of balance, in turn, results in unemployment and economic slack, unless it is offset by adequate expansionary economic policies by the Government. The Federal Government can and should counter such lack of balance in the private economy, by placing more funds into the spending stream, through expenditures and investments, than it withdraws from the spending stream, through tax receipts.

During most of the period between 1953 and 1960, the Federal Government followed a rather tight and restrictive fiscal policy, with emphasis on attempting to balance the budget books rather than attempting to balance the economy. The restrictive fiscal policy, added to the trend toward private oversavings, was a major factor in the economy's slow rate of economic growth and rising unemployment. In a period of economic slack and a tendency toward private oversavings, the Federal Government took too much money out of the economy's spending stream, through taxes, in relation to its expenditures and investments.

Since 1961, the Federal Government's fiscal policy has attempted to offset the lack of balance in the private economy, rather than to eliminate or reduce the imbalance. However, it was not until adoption of the Revenue Act of 1964, involving a substantial tax cut in a period of economic upturn, that the Government provided a strong dose of expansionary fiscal policy medicine by adding substantially more money into the spending stream, in 1964, than it withdrew. The reduction of unemployment from 5.7 percent of the labor force in 1963 to 5.2 percent in 1964 is an indication of the beneficial impact of the tax cut on the level of economic activities.

But the tax cut adopted in 1964 was not enough, in itself, to achieve full employment. Almost every forecast of economic trends for 1965 indicates the likelihood of stable or rising unemployment unless additional, expansionary fiscal policy measures are taken.

As the economy grows, tax revenues increase, along with the expansion of individual and business incomes. It has been estimated that Federal tax revenues will rise approximately $6 to $7 billion a year at high levels of economic activities, under present tax rates, in the next few years.

Such expansion of revenues will permit increasing Federal investment in human and material resources, which the AFL–CIO views to be the top priority need, as well as some reduction of the relative tax burden on low- and moderate-income families. Indeed, unless our national fiscal policy moves in that direction, the Federal Government will take too much money out of the economy's spending stream, aggravating the imbalance in the private economy, and the Nation will not be able to achieve and sustain high levels of economic activities.

In the next few years, a continuing and deliberately expansionary fiscal policy is essential until the economy achieves full employment; when full employment is at long last attained, fiscal policy should shift to assist in sustaining full employment and maximum use of our productive resources. Should the Government's taxing, spending, and investment policies fail to provide adequate funds in the economy's spending stream, however, high levels of unemployment will persist, as well as large amounts of idle productive capacity.

The Revenue Act of 1964 has already cut taxes by over $11 billion. In the coming years, the major emphasis should be given to increasing Government investment to meet the public and social service requirements of a growing and increasingly urban population.

In the AFL–CIO view, the top fiscal policy priority should be given to increasing Federal investments in job-creating measures to improve our public services—measures to create job opportunities and to effectively utilize our expanding productive capacity, as well as to provide public improvements of lasting worth. Federal aid to education, for health facilities, for housing, community public works, and regional redevelopment, as well as for expansion of the antipoverty program, for example, are measures of vital importance to the American people and deserve the highest priority.

Such measures involve direct Federal programs and guaranteed loans, as well as Federal grants-in-aid to the States and local governments for specific programs, with Federal standards. The AFL–CIO is opposed to untied grants to the States that are not directly related to specific programs and that lack appropriate Federal standards.

A substantial and continuing increase of Federal investment programs, in the next several years, is essential to meet the needs of American society, as well as the requirements of a rational fiscal policy. They will also create jobs—badly needed job opportunities in a period of technological revolution. In addition, by providing public and social services for low-income families, they can provide some counter to the poor distribution of income which has been fostered, in part, by the Revenue Acts of 1954 and 1962.

This emphasis on Federal investments would be more easily understood if the United States, like other Western nations, adopted a capital budget—an accounting that truly distinguishes between costs and investment. The Federal Government's accounts should separate housekeeping costs and national security outlays, on the one hand, and on the other, the sums used to create, improve, or acquire assets, or advanced as recoverable loans. This is the general practice in private business, in many States and cities, and even in well-run individual households.

Within the context of such expansionary fiscal policy requirements and the top priority emphasis, which I believe should be placed on rising Federal investments, it will be possible to reduce Federal excise taxes by about $2 billion in 1965. Such modest first-step reduction of Federal excises, it seems to me, is both feasible and necessary in 1965 as part of the needed expansionary fiscal policy and to reduce or eliminate those excises that place the greatest burden on low- and moderate-income groups. In reducing Federal excise taxes, emphasis should be placed on eliminating or reducing those excises that are most regressive in their impact.

As we move through the next several years, the continuing rise of Federal revenues, at a rate of about $6 to $7 billion a year, will permit and indeed, require, the substantial increases of Federal investments indicated above. Depending on the actual level of increases of Federal investments, however, some further adjustments of the tax structure should be possible within the next 5 to 10 years.

Such adjustments of the Federal tax structure should place greatest emphasis on the complete elimination of income taxes upon those who are at or below the poverty level as defined by the President's Council of Economic Advisers—$3,000 income for a family and $1,500 for an individual—and on easing the disproportionate tax burden on low- and moderate-income groups. It is shameful that something like $100 million of Federal income tax revenues is still collected from people whom the Government defines as poor, as well as about $200 million from excise taxes. Elimination of Federal income taxes on the poor and reduction of the relative weight of Federal taxes on moderate-income groups would improve the equity of the tax structure and reduce the tendency toward oversavings in the private economy.

In addition to the reduction of the relative tax burden on low- and moderate-income families, further revision of the Federal tax structure in the years ahead should provide effective action against loopholes of special privilege—loopholes which primarily benefit wealthy taxpayers and whose spread has tended to erode the progressivity of the Federal tax system.

It would be wise for the Joint Economic Committee to examine carefully, within the next few years, the proposal to apply a Federal tax credit against income tax payments to the States as a possible means of increasing the politically feasible tax base of most States and to encourage their adoption of income taxes, instead of their increasing reliance on property and sales taxation.

The maintenance of full employment policy and increased social equity also requires flexible fiscal policy; for example, to counter recessionary trends early enough, before they gain downward momentum. The AFL–CIO supports the use of a temporary rise of Federal public works investment and/or a temporary tax reduction to counter recessionary trends, as soon as they become clearly apparent. It is my hope that the Congress will soon carefully examine this issue and provide a constitutional and workable means for utilizing such flexible policy tools.

The American Life Convention: Statement by Arthur S. Fefferman, Director of Economic Analysis

Because of the pressure of time, we have not been able to follow our usual procedures in ascertaining the position of the life insurance business on these issues for the purpose of answering your letter. For this reason I am submitting the following views in my capacity as an economist rather than as a representative of the life insurance business.

There is, of course, widespread recognition that Federal taxes and expenditures necessarily have an important impact on our economy. Much attention, and rightly so, has been focused on directing Federal fiscal policy to the goals of high-level economic activity and economic growth. Greater recognition, however, should be given to the need for attaining these goals within the framework of stable prices. A stable price level makes a positive contribution to the achievement of long-range economic growth by avoiding the speculative booms and excesses which inevitably develop in inflationary periods and which inevitably are followed by corrective reactions that dampen economic production. Stable prices are also of the utmost importance in protecting the life insurance investments of the 120 million policyholders in this country and their beneficiaries.

Tax policy should have as its long-run objective the reduction of income tax rates from their high wartime levels. The 1964 Revenue Act has made a significant start in this direction. However, even after the reduction in tax rates under the 1964 act becomes fully effective, individual income tax rates will range as high as 70 percent and the combined corporate normal tax and surtax will reach 48 percent. Rates at these levels are still far from ideal. Lower rates would make a substantial contribution toward maintaining a high-level economy by bolstering both investment and consumption.

Optimistically, further tax reduction will be possible if the economy remains vigorous without inflation, and if expenditures, which now show signs of topping off, are kept under control. Under such conditions, tax receipts, even under the new tax law, may be expected to grow $5 billion or $6 billion a year, providing revenue for both further tax reduction and a contribution to a balanced budget.

However, tax policy should be kept flexible, responding to changing economic conditions. Although the long-range goal of tax policy should be to cut the tax burden drastically, specific tax reductions should not be scheduled far ahead in future years because we cannot know now what economic conditions will then prevail. There should be no substantial tax reduction in 1965 if significant inflationary pressures develop next year. In such a situation, tax cuts would help build up inflationary pressures, with dangerous implications for our economy.

On the other hand, should the economy show marked signs of faltering in 1965, further tax reduction should be given high priority.

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as a means of maintaining prosperous business conditions. The 1964 Revenue Act has shown how effective tax reduction can be for this purpose. In this respect, tax cuts are far preferable to expenditure increases. Basically, the advantage of tax cuts is that they release to the private sector of the economy funds which can be used for private consumption and investment. They, therefore, give consumers and investors the greatest freedom of choice in allocating the Nation's resources.

Moreover, monetary and tax policy should work together as a team to secure the desired goals. Monetary policy, like tax policy, should be kept flexible to respond to changing economic conditions. Particularly after a tax cut as large as the one enacted this year, monetary tools should be kept ready for use if marked inflationary pressures arise.

Finally, we should recognize that there are limits to the use of broad-gaged tools, like tax cuts and monetary policy, for the purpose of encouraging growth and stimulating employment. It is essential to use these tools for such objectives. But if the broad tax and monetary tools are pushed too far in an attempt to secure full employment, they will generate enormous inflationary pressures, and disrupt the economy. In general, the best approach would be to use the broad monetary and tax tools to maintain generally prosperous business conditions. At this point narrower and more specific tools should be brought to play to attack unemployment and facilitate economic growth.

The Chamber of Commerce of the United States: Statement by Carl H. Madden, Director, Economic Research

I regard the steady climb in spending by State and local governments and their expanding need for revenues from sources other than the property tax as the most important revenue problem facing the Nation.

In this connection it is high time for a better integration of Federal-State tax policies—less reliance on grants-in-aid and more reliance on revenues raised at the State level. As general guidelines it has frequently been suggested that there be (1) reduced reliance by the Federal Government on corporate and personal income taxes in return for adoption of a uniform, low-rate Federal retail sales tax (with certain exclusions); and (2) increased reliance by States on mildly graduated personal income taxes and less reliance on property and excise taxes. Adjusted income is the most equitable basis for taxation, especially in an economy where close to 80 percent of national income is in the form of wages and salaries. At the same time, it must be recognized that the changes suggested would be introduced gradually and would not contemplate a complete displacement of State property taxes by State income taxes.

The next most important issue is the use of full employment budget analysis as a guide to Federal fiscal policy determination. If aggregate demand at close to full employment generates such a large tax surplus that full employment is not attained, Federal income tax rates should be reduced. The alternative of increased Federal spending is undesirable, not only because it is inflexible, but also because it weakens the private sector at the expense of the public sector. By inflexibility in this context I mean a tendency for spending programs to be maintained once instituted.

The third most important issue concerns the relationship of Federal fiscal policy to monetary policy. In the past, fiscal and monetary policies have been considered complementary, so that coordinate tightness or ease in both policies at once were considered reinforcing and desirable. The Council of Economic Advisers has stated in its 1964 Economic Report (p. 44), however, that a tight money policy may be desirable to restrain an overexuberant investment boom while an easy fiscal policy might be used simultaneously to encourage consumption spending. Conversely, an easy-money policy might be employed in concert with a tight fiscal policy to encourage investment and discourage consumption spending. Although the concept of an appropriate fiscal-monetary policy "mix" is intriguing, it is as yet untested in this country. Careful analysis of this proposal is called for because of the relationship between consumption spending and the investment spending induced thereby.

Finally, although the Joint Economic Committee has already looked into the question of improving the processing and reporting of the Federal budget, further study of this matter is called for.

The Conference on Economic Progress: Statement by Leon H. Keyserling, Former Chairman, Council of Economic Advisers; Consulting Economist and Attorney; President, Conference on Economic Progress

I am glad to note that the Fiscal Policy Subcommittee is undertaking a survey to determine the important fiscal policy issues likely to face the Congress and the Nation in the coming decade.

I have noted that lengthy, documented responses are not required at this time, and in any event my views on the subject have been set forth comprehensively at various times when I have testified before the Joint Economic Committee or submitted statements to it, including especially my statement submitted on behalf of the Conference on Economic Progress, incorporated in the hearings of the Joint Economic Committee on the January 1964 Report of the President. My views on the same subject have also been set forth comprehensively in various conference studies, copies of which have been made available to the members of the Joint Economic Committee, including especially "The Toll of Rising Interest Rates," August 1964; "Two Top-Priority Programs To Reduce Unemployment," December 1963; "Taxes and the Public Interest," June 1963; and "Key Policies for Full Employment," September 1962.

In summary, my views with regard to the emerging issues which should require the attention of the Congress in the near future include the following:

(1) What additional national economic policies, or changes in policies, are needed to make more headway against unemployment? I do not believe that full-time unemployment of about 5 percent now, and a true level of unemployment (taking into account the full-time equivalent of part-time unemployment, and the concealed unemployment resulting from insufficient growth in the civilian labor force due to insufficient job opportunity) of about about 8½ percent now, represent an acceptable rate of progress toward maximum employment;

(2) Is there merit in the current idea, widely held, that a continuation of the current economic upturn would increase inflationary dangers to the point calling for consideration in the near future of changes in fiscal and/or monetary policies designed to combat inflation? My own answer to this question would be in the negative; indeed, I believe that more effective stimulative policies than we now have are called for to make more progress toward reducing unemployment. Further, I believe that it would be desirable for the Joint Economic Committee to examine again, in this instance through the Fiscal Policy Subcommittee, whether the general theory that maximum employment and an adequate rate of economic growth tend to induce more inflation in the long run than has been induced by the deficient economic performance since early 1953. My own view is that the evidence accumulated since 1953 tends to substantiate my position that a more nearly optimum

economic performance would be more conducive to price stability in the long run than the inadequate economic performance which we have been experiencing, and further that we should not in any event accept policies designed to restrain inflation which cost the economy far more in idle plant and manpower than the benefits derived from their actual or dubious consequences in terms of preventing inflation;

(3) Has the rate of economic growth during the past 2 years or so been anywhere near adequate? My own view is that it has been very inadequate, first, because the needed growth rate should be measured against the requirements for a restoration of maximum employment and production within a reasonable period of time, and not measured against the needed growth rate after such restoration; and second, because the actual growth rate during the past 2 years or so has been substantially less than the rate which would be required merely to absorb the annual increments in the labor force and in productivity which would be called for annually under the stimulus of reasonably full resource use;

(4) Do the tax reductions of 1962 and 1964 represent desirable fiscal policies, or, if it is deemed too late to reexamine this question (which I think would be a mistake), do these enormous tax reductions already undertaken justify consideration of further large tax reductions in the near future, as the enlargement of the GNP yields additional revenues to the Federal Government at now existing tax rates? My own view is that the tax reductions already undertaken have already been overgenerous, particularly in terms of distribution among recipients both personal and corporate; that they have tended on net balance to be regressive in nature, which is undesirable on both economic and social grounds, particularly in view of the highly regressive nature of State and local taxation; and that tax reduction at best is a very wasteful and relatively ineffectual way of reducing unemployment, especially in view of the trends in technology and automation which call for vast expansions of types of investment to create employment (and also to meet great public needs) which are hardly stimulated by tax reduction;

(5) How can we meet our great public needs, in such fields as housing, education, health, urban renewal, and resources development, if we continue the policy of handing out in more tax reductions the increased revenues resulting from economic growth, inadequate though this growth still tends to be? The argument that still more tax reduction will activate the economy sufficiently to provide enough tax revenues to meet these great priorities of public needs seems to me manifestly to be moving around in a circle, for if the increased revenues resulting from economic growth are promised away in more tax reduction even before they are in hand, or handed out in more tax reduction when they are in hand, they will never be available to meet these great priorities of public needs. The Joint Economic Committee is well familiar with the urgency of these public needs, and also well familiar with the trend of domestic public outlays at the Federal level in a downward direction, whether measured on a per capita basis relative to the whole population or measured as a percent of the GNP;

(6) How can we expect the States and localities, as distinguished from the Federal Government, to assume an increasing share of the responsibility for meeting these great public needs, when the State and

local debts have increased about 300 percent since 1952, while the Federal debt has increased only about 16 percent, taking account also of the extremely regressive nature of State and local taxation?;

(7) How can we reconcile recent and prospective tax reductions with the bare minimum requirements for a persistent and successful war against poverty in the United States, insofar as this war obviously requires a wide range of policies and programs depending upon public outlays?;

(8) Can we restore and maintain maximum employment and production if the money supply continues to expand at no more rapid a rate than has been permitted on the average during the past decade or longer, including recent years and the current year, by Federal Reserve policies, and if interest rates continue in the long run their very large regressive effects upon income distribution? My own view is that there is no justification for the prevalent monetary policies, and that they have been tested and found wanting for long enough to make it desirable that the Congress itself take the lead in insisting that these policies be revised along lines recently recommended by some members of the Joint Economic Committee and by Congressman Patman's subcommittee;

(9) Can the Employment Act of 1946 be a fully effective instrument for the restoration and maintenance of maximum employment, production and purchasing power, so long as the Economic Reports of the President under that act do not contain short- and long-range quantitative goals for these maximums as required by the act itself, and can there without such goals be the fully integrated and consistent economic and financial policies which the act contemplates? In this connection, I note that section of your letter which refers to "the applicability of full employment budget analysis to policy determination." I do not believe that the processes are now in motion to bring this about effectively through the initial instrument of the President's Economic Reports. Just as one example, social security and housing policies, though they are not for the most part fiscal measures as commonly defined, are quite as important from the viewpoint of employment and economic growth as those measures which are commonly looked upon as fiscal measures. The same might also be said with validity of the whole national farm policy. Yet these profoundly important aspects of national economic policies are not detailed with great significance in the Economic Reports, which reports embody the first step toward effective evaluation of national economic policies by the Joint Economic Committee and its various subcommittees.

The Life Insurance Association of America: Statement by James J. O'Leary, Vice President and Director of Economic Research

I am pleased to participate in the survey which the Fiscal Policy Subcommittee has undertaken to determine the important fiscal policy issues likely to face the Congress and the Nation in the coming decade. I am writing to give you some of my personal views as an economist. Due to the shortage of time, it has not been possible to clear these ideas with the proper committees in our industry.

I believe that the most important question to be considered by your subcommittee is how fiscal policy can best be employed in the next decade to provide favorable conditions for high employment and sound economic growth, along with stability of the general price level. Of special importance is the question of the impact of our Federal tax system on sound economic growth. Evidence of the great importance which the life insurance business attaches to this question is the fact that 2 years ago the Life Insurance Association of America made a grant of $200,000 to the National Bureau of Economic Research for their research project, "Taxation and Economic Growth." The findings of this study, which are beginning to emerge, should be of aid to your subcommittee.

I should think that one of the most valuable things which your subcommittee could do at this time would be to undertake an analysis of the effects of the personal and corporate income tax cuts which were enacted this year. I am suggesting an intensive piece of research to uncover how the tax reductions have affected consumer and corporate spending. In this connection I would also like to see a careful study made of the impact of the liberalized depreciation guidelines and the investment credit. I think that these tax reductions and revisions as a whole have had a highly significant effect toward economic expansion, but it is important to examine their impact in detail in order to provide the best basis of fact upon which to decide upon future tax measures.

The current expansion of general business activity is now in its 43d month. From the first quarter of 1961 through the third quarter of 1964 the GNP has risen from a seasonally adjusted annual rate of $500.4 to $627.5 billion, or 25.5 percent, and the Federal Reserve Board index of industrial production has increased 30 percent. Aside from the fact that this expansion has not reduced the unemployment rate to a lower and more acceptable level, it has been substantial and has proceeded without the development of the various excesses which often characterize this stage of the business cycle. However, we are now in the real testing period of the expansion in which the rate of utilization of our resources has moved to a high level and upward pressures on the price level must be a matter of public concern.

I believe that both fiscal and monetary policy measures have contributed heavily to the expansion. Credit has been easily available since mid-1960 and lending institutions have aggressively expanded their loans and investments and have thus encouraged a great expansion of private and public construction and consumer spending. After more than 4 years of easy credit, however, I believe that if general business activity should level off or decline sometime next year we could not count on continued easy credit as a means of stimulating further expansion. It is likely that the expansionary power of credit policy has pretty much spent its force. Under these conditions I think that fiscal policy would be required to carry the lion's share of the burden of encouraging further expansion.

The direction of fiscal policy in the past couple of years has, in my view, been most constructive. As a nation we have embarked on a fiscal program of maintaining a strict limit on the aggregate of Federal spending and employing Federal tax reduction and revision to stimulate rising personal consumption and a higher rate of capital spending by business and industry. This program recognizes that the wellspring of a growing economy is individual initiative and the spirit to innovate and work harder. A higher growth rate, on a sound basis, requires a higher rate of personal saving and a higher rate of capital spending. At the same time, there must be a balanced growth in consumer spending. I think that the fiscal program we have undertaken recognizes these principles.

Our Federal tax burden is still much too high. I hope, therefore, that as conditions permit, the Congress will take additional steps to reduce the burden of taxes on consumers and producers in a balanced manner. At the same time, I hope that strict limits will be placed upon any further rise in Federal spending, and that within these limits some means will be found to turn over a portion of Federal revenues to the States where it can be directed better to local needs.

If we go further in the direction I have outlined, however, it is important that at all times the Government must be prepared to employ monetary and debt management measures as a means of protecting the value of the dollar. I have been alarmed, in this regard, at the tendency for general credit control measures to be abandoned as a means of combating upward pressures in the price level.

THE NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS: STATEMENT BY DR. GROVER W. ENSLEY, EXECUTIVE VICE PRESIDENT

At the risk of oversimplification, we can probably separate the types of fiscal policy questions that are likely to be of importance in the years ahead into: (1) issues concerned primarily with the proper relation of fiscal policy to short-term fluctuations in the economy and to Government stabilization programs; and (2) issues concerned primarily with the longer-run relationship between fiscal policy and the pace and character of economic growth.

With regard to the proper short-run role of fiscal policy, I believe that there is a long overdue need to make fiscal policy a more flexible and effective tool in combating swings in the business cycle. The "automatic" stabilization functions already performed by changes in Federal tax receipts and certain types of Government transfer payments should be supplemented by a widened range of discretionary fiscal powers, particularly in the area of short-run changes in tax rates.

This need was, of course, fully recognized in the proposals for standby tax reduction powers and capital spending programs advanced by President Kennedy in his first Economic Report. Without going into the specific merits of these particular proposals, their recognition of the largely untapped potential of discretionary fiscal policy should not go unheeded in the years ahead. In this regard, it is encouraging to note that President Johnson has also recognized the need for greater speed and flexibility in the use of fiscal policy to combat incipient or actual recession.

A flexible fiscal policy would be an invaluable supplement to flexible monetary policy, particularly at a time when the scope of monetary policy is somewhat circumscribed by international considerations. Indeed, there is sparse logic in having one and not having the other. The goal of economic stabilization would be furthered most efficiently by the simultaneous use of flexible monetary and flexible fiscal policies. With flexibility possible in both of these important areas of Government activity, the specific outlines of each type of policy and its relative importance within an overall stabilization program could be tailored more closely to the circumstances and special policy requirements of an emerging situation. The important point is that a widened range of possible Government responses to cyclical economic fluctuations would be provided with flexible and discretionary tax and spending powers. Whether and how such flexibility is achieved should be one of the major fiscal policy issues confronting us in the years ahead.

Turning to the second broad group of fiscal policy issues, those related to the type and pace of economic growth that we desire in the years ahead, a number of basic questions present themselves. Assuming that a more rapid rate of growth is both desirable and necessary if we are to approach full utilization of our human and physical resources, how can fiscal policy help to attain this objective? At the two extremes, faster growth could be promoted either by substantially increasing Federal spending programs or by a comprehensive program of tax reductions. In practice, the choice will not be so simple, and it is highly probable that actual Government policy will reflect elements of both approaches.

As a general proposition, however, in a free enterprise economy the primary emphasis of Government policy should be directed toward stimulating the performance of the private sectors, while remaining ready and able to undertake needed programs in such broad areas of public concern as national defense and social welfare. And one of the most effective means of stimulating private demand is through tax reduction.

The administration is apparently convinced of the desirability of further tax reduction as a spur to private demand and initiative. It is likely, therefore, that the reduction or elimination of various excise taxes and further reductions in personal and corporate income tax rates will inevitably be major fiscal policy issues for years to come.

While the major emphasis should rightly be directed toward lightening the unduly heavy burden of the personal income tax, it will also be highly important to strengthen more direct incentives to business investment and job creation. Further reduction in the corporate tax rate, which is still considerably higher than in most of the other leading industrial nations, would reinforce the incentives for increasing investment induced by higher levels of after-tax incomes and potential consumer spending power.

If a faster rate of economic growth is to be achieved in a noninflationary manner, however, it will be necessary not only to stimulate potential investment demand but, equally important, to insure that a sufficient volume of private saving is made available to finance such investment. The importance of this fact was highlighted in Simon Kuznets' massive study of "Capital in the American Economy," which indicated that inadequate rates of economic growth in the past have tended to reflect an inadequate supply of savings, rather than a lack of investment opportunities.

In broadly simplified terms, a rising level of national income naturally generates a higher level of personal saving (nonspending). If the rise in income is not to level off or decline it is necessary to channel this saving into private investment spending or, failing this, to increase Government outlays. Should the basic decision be made, as I think it should and will be, to achieve accelerated economic growth through primary reliance upon private spending, then it will be more important than ever before to improve the efficiency of our financial system in generating and channeling savings into private investment outlets.

Deposit-type financial institutions have come to play an increasingly important role in performing this intermediating function, but if they are to meet the growing requirements of the future a great deal more will have to be done to enhance their ability to attract savings and to widen their range of investment outlets.

A major step in this direction was taken by the administration last summer when it sponsored legislation in the Congress that would permit mutual savings banks to be organized under Federal charters in any State, a privilege long available to commercial banks, savings and loan associations, and credit unions. At present, mutual savings banks are organized and operate under State charter in only 18 States, with most of the industry's assets centered in the New England and Middle Atlantic States. A wide range of evidence indicates that the presence of mutual savings banks in an area tends to generate a greater total volume of savings at all types of local institutions. Thus, extension of savings banks throughout the country could be expected to mobilize a greater volume of locally held capital for local investment, thereby improving the efficiency of our private savings-investment process and furthering national economic goals.

While there is a clearly indicated long-range need to reduce further the drag of our present tax structure on private spending and investment, the actual timing, nature and extent of future tax reduction will necessarily depend upon such short-run factors as the current and prospective state of the economy and the Federal budget. In this regard, full employment budget analysis will continue to be a helpful tool in determining the proper course of Federal fiscal policy, although by no means the only tool.

Such analysis is particularly important in judging the economic impact of discretionary changes in Federal spending programs or in tax policy, both for short-run purposes of economic stabilization and for longer-run purposes of stimulating economic growth. With regard to the latter, full employment budget analysis could be used, for example, to determine the present size of the full employment surplus and the various combinations of changes in spending or tax programs that could be expected to achieve the objectives of the Employment Act of 1946.

It should be noted, however, that determining the size of the full employment surplus is far from an exact science. Consequently, while use of this technique is a valuable means of indicating the likely impact of present and alternative fiscal policies on aggregate demand, and of shedding new light on the possibilities of nonfiscal policies, it is not a magic formula. Recognizing its value, we should also recognize the danger of using it in a mechanistic way. As a tool for policy determination, therefore, it should be utilized with full awareness of its inherent statistical weaknesses.

A long-run problem closely related to the question of overall economic growth and the problems of poverty in our society will be the need to find some means of supplementing the limited revenue-raising capabilities of State and local governments, as population growth and demands for essential services continue to expand in the years ahead. This, indeed, will be one of the most complex and far-reaching problems to confront us.

A comprehensive program of tax reduction at the Federal level would provide greater leeway for increased taxes at the non-Federal level, thus alleviating some of these pressures. And the problem would be further alleviated by channeling a share of Federal revenues back to the States. Finally, the possibility of expanding grant-in-aid under existing and new programs should be explored.

With regard to revenue sharing, there will undoubtedly be widespread discussion over whether or not such grants should be subject to specified conditions. A program of unconditional transfer perhaps with very broad general safeguards, has considerable merit as a supplement to the grants-in-aid approach. In effect, it would leave the traditional decisionmaking prerogatives of the States undisturbed while placing the efficient tax-collecting machinery of the Federal Government at their disposal.

The growth in Federal revenues thrown off by an expanding economy can, of course, be put to many uses. My own opinion is that a general program of incentive-building tax reduction, combined with selective increases in essential Federal spending programs and increased financial aid to State and local governments, would do much toward promoting not only a faster rate of economic growth and higher level of living, but also a more vigorous system of private enterprise and local government

The National Association of Tax Administrators: Statement by Charles F. Conlon, Executive Secretary

I am happy to respond to Mrs. Griffiths' invitation to comment briefly on fiscal problems facing Congress. I would like to refer particularly to their impact on State and local revenue and expenditure policies.

What might be termed the State-local fiscal dilemma is due to the fact that the expenditures required to keep pace with the growth in population and general economic and technical development outrun the productivity of the State-local revenue system with the result that it is necessary periodically to beef up the system by increasing tax rates or by adopting new taxes and in some instances by doing both.

The dimension and urgency of the State-local expenditure problem and the implications of the increase in these expenditures relative to comparable Federal expenditures probably are not yet fully appreciated although the hard facts about them have been laid on the line as, for example, by President Kennedy in his 1963 Economic Report and by President Johnson in his comment in the Budget in Brief for 1965.

President Kennedy identified the major factors building up the pressure on the expenditure side of State and local budgets:

> The Federal budget is hard pressed by urgent responsibilities for free world defense and by vital tasks at home. But the fiscal requirements laid upon our States, cities, school districts, and other units of local government are even more pressing. It is here that the first impacts fall—of rapidly expanding populations, especially at both ends of the age distribution; of mushrooming cities; of continuing shift to new modes of transportation; of demands for more and better education; of problems of crime and delinquency; of new opportunities to combat ancient problems of physical and mental health; of the recreational and cultural needs of an urban society. (Economic Report of the President, 1963 (p. xxi).)

President Johnson, a year later, emphasized the magnitude as well as the growth of State and local purchases of goods and services relative to comparable Federal purchases:

> Compared to the rise in Federal purchases of goods and services of 54 percent since 1955, purchases by State and local governments will increase by an estimated 123 percent. The Federal Government's proportion of the output bought by all levels of government will fall from 61 percent in 1955 to 52 percent in 1965, as State and local governments continue to use a relatively increasing share of the resources used by governments. Based on recent experience, the increase in State and local purchases of goods and services in 1965 will be over $4 billion, in contrast to $1.3 billion estimated for the Federal Government. (Budget in Brief, p. 19.)

That President Johnson's estimates were realistic is indicated by subsequent developments. From the fourth quarter of 1963 to the third quarter of 1964, Federal purchases increased by $1.1 billion on an annual rate basis while State and local purchases went up $4.1 billion.

The impact of this shift in the relative growth of State and local expenditures vis-a-vis Federal expenditures shows up on the tax side of State and local budgets and is the direct cause of the need to beef up the State-local tax system from time to time. A survey of new enactments and rate changes in the State income tax and major excise fields indicates just how extensive this beefing up process is. In the period 1959–63, the State legislatures enacted 14 corporation income tax rate increases; 18 personal income tax boosts plus 3 new adoptions; 48 tobacco tax rate increases and 2 new adoptions; 18 general sales tax rate increases and 4 new adoptions; and 41 alcoholic beverage tax rate boosts and 1 new adoption.

This recital, however, does not tell the whole tax story. Equally important is the property tax—an exclusive local revenue source in most States but one which still accounts for something more than 45 percent of all State and local taxes. In the period 1952–63, the yield of the property tax went up an average of 8.5 percent each year.

How long the rising curve of State and local expenditure will continue undampened is a matter of conjecture. It is quite possible, though, that the next decade will see a further substantial expansion of government services—in public safety and its manifold aspects, for example, and in medical and public health programs and others associated with urban growth—transportation, waste disposal, and protection against pollution of air and water. Some of these programs will entail heavy capital investments as well as purely service costs. All are in addition to projected increases in costs for those functions—education, welfare, and highways—that account now for the bulk of State and local expenditures. To the extent that this combination of requirements would tend to maintain the rising curve of State and local expenditures now in evidence, the probability is that the States and localities would have to continue to resort to the same beefing up process so familiar in the past decade.

This process, however, is a difficult one and it becomes more so with repetition. At the State and local level the tax problem is one that overshadows and probably determines all others. I would hazard the guess that resistance to higher taxes is perhaps the greatest obstacle to the exercise of executive and legislative leadership in State and local government today. Also, as taxes go up, the question of the "tax climate" of a particular State or locality and its ability to expand job openings become of increasing concern. Even aside from this consideration the existence of State borders and the mobility of persons, resources, and trade are facts of life which tend to put a ceiling on tax rates far under their Federal counterparts.

There are several respects in which the fiscal policies followed by the Congress could have an important bearing on the future development of State and local tax and expenditure policies. First, any action taken by Congress to stimulate economic growth—for example, the recent major tax cut—will improve the productivity of the existing State-local tax system and thus tend to reduce the incidence of beefing up operations. Second, while by means of grants-in-aid Congress has provided Federal funds to support a variety of State-local programs, it has not, heretofore, made use of its tax powers to collect taxes so to speak, on behalf of the States. This possibility was suggested in President Johnson's statement of October 28. It is a genuinely new approach to a problem that has been growing in complexity and it merits the most serious consideration.

The unencumbered distribution of tax revenues as such has one great advantage over the grants-in-aid program in that the revenue distributed may be used for those programs or purposes which have a priority in the particular State or locality. The grant program, on the other hand, is tied to a particular function. Differences among the States as to specific needs and in the matter of emphasis to be given one program or another cannot be accommodated where the grant approach is used.

Another point about a tax distribution program is that it would eliminate much of what might be called interstate tax competition and the resulting preoccupation with the maintenance of a "favorable" State tax climate at no matter what cost in terms of deficiencies in performance standards of vital State and local government programs.

A third area where the fiscal policies followed by Congress are of immense importance to State and local government is that of the price level. Achievement of a stable or mildly declining average price level along the lines recommended by the Joint Economic Committee in its 1964 report would on balance lessen the pressure exerted on the cost side of the State-local budget.

The National Federation of Independent Unions: Statement by Don Mahon, Executive Secretary

We are replying to recent letter from Martha W. Griffiths, chairman, Subcommittee on Fiscal Policy, with respect to the survey the committee is undertaking to determine the important fiscal policy issues facing Congress and this Nation during the coming decade.

Our organization, the National Federation of Independent Unions, and its affiliates, are certainly interested in this matter.

Our primary concern with regard to Federal revenue and expenditures is closely related to the future welfare of our members. Failure to give due consideration now, or make provisions for the future, can gravely endanger the social security protection that has been built up from the contributions of themselves and their employers.

Constant and progressive planning is needed to supplement and coordinate the efforts of labor to keep pace with or offset the threats of automation and constantly changing production methods which eliminate jobs.

Revisions of the present tax structure are certainly necessary to make it possible for working families to provide a college education and adequate training for the constantly growing number of young people who are preparing for their place in the economic life of this country.

Allowable deductions for such educational expenditures, as well as grants or loans to qualified students, would be another important factor in developing this priceless asset of our country.

Positive measures to protect American labor and agriculture from the impact of imports from low-wage countries is also an urgent necessity. This requires long-range consideration in order to encourage the further development of our agriculture and manufacturing facilities as well as defending skilled workers and their employers who are responsible for the American record of production.

The New York Stock Exchange: Statement by G. Keith Funston, President

In the "ideal" utopian world tucked away in the back of minds of men, there will be no taxes. The seepage of such an idea into the real world can deter one's efforts to work for as efficient a tax system as possible. Practical perfection in the area of taxation and fiscal policy rests in striving to make the system as efficient as possible and striving to insure that the side effects of taxation on business, commerce, and consumers are minimal.

This position paper suggests time-honored criteria which might be employed in measuring the efficiency and viability of the present system of Federal taxation of this Nation. It evaluates present taxing techniques against these standards. It also presents the considered opinion of the exchange on those matters of taxation closest to our interests. These include: capital gains, double taxation of dividends, the interest equilization tax, and the present status of so-called nuisance taxes on our industry, such as the stamp and transfer taxes.

CRITERIA FOR EVALUATING A SYSTEM OF TAXATION

History often provides useful guidance in developing perspective and insights on current problems. On the subject of taxation, the writings of John Stuart Mill are a landmark. Mill furnished us over 100 years ago with a type of golden rule against which to measure the efficiency and utility of various systems of taxation. Although we have come a long way since 1848 in tax theory and taxing techniques, an evaluation of our present tax structure in the light of the maxims established by John Stuart Mill should prove helpful. The four principles of taxation in his own words were:

1. Subjects of every State ought to contribute to the support of the government as nearly as possible according to their respective abilities.
2. The tax which each individual is bound to pay ought to be certain and not arbitrary.
3. Every tax ought to be levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it.
4. Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the State.

For shorthand purposes, we will refer to these principles as follows: A tax should be (1) equitable; (2) certain and not arbitrary; (3) conveniently payable; and (4) have minimal effect on the flow of goods and services through the private economy.

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IS THE PRESENT FEDERAL TAX SYSTEM EQUITABLE?

The present system of Federal taxation is found wanting when evaluated in the light of Mill's criterion of equity. Its revenues flow predominantly, in fact, excessively, from one source—individual and corporate income taxes. In combination, income taxes account for over two-thirds of cash budget receipts, an exceedingly high percentage by comparison with the revenue flows in other nations of the Western World. Exhibit A shows the sources of tax receipts by type of tax on a consolidated cash basis for the fiscal year 1963.

Another basis for assessing the relative balance and equity of our tax system rests in classification of taxes into direct and indirect categories. The results of such an analysis are presented in the report of the Joint Economic Committee entitled "The Federal Tax System: Facts and Problems, 1964." A summary of the findings appears in exhibit B. It shows that compared with eight other industrialized countries, the United States relies more heavily on direct as opposed to indirect taxes. Only in the Netherlands and Sweden do direct taxes, as a percent of total taxes, exceed the ratio in the United States. Only in Sweden do income taxes bring in a larger share of total revenues. We collect 57 percent of our total Federal, State, and local taxes in the form of direct taxes. If Federal taxes alone were considered, the comparison would be even less favorable for the United States. (On the State and local level, interestingly, once again heavy reliance is placed on a single tax, the property tax. Approximately 13 percent of total tax dollars come from property taxes. In Canada, the percentage is 14.2 percent. In no other nation does it exceed 6 percent of total tax revenues.)

The lack of balance and the consequent inequity is perhaps the most serious defect in our present Federal system of taxation. The root of the problem may well rest in the American habit of examining and appraising the tax structure only in time of crisis. A feeling that we should leave well enough alone, or, if we ignore the tax question, perhaps it will go away, seems to be at work. The major revenue-producing innovations in this Nation were developed, more often than not, in an atmosphere of crisis when revenue needs were imperative. The present-day excise taxes were designed in a wartime environment. The present level of rates and the withholding feature of Federal income taxation both have a wartime heritage. At such time, when pressures for revenues are great, men are inclined to take the easy way out and enact those taxes which will produce revenues of the desired amount with certainty. In addition, at such time, taxing techniques may be used to control the flow of goods in a manner which will aid the war or defense effort. The distortion to equity on this count can be great and it can intensify as time passes and the original imperatives fade.

DOES THE FEDERAL TAX SYSTEM DISTORT THE FLOW OF GOODS AND SERVICES IN THE ECONOMY?

The extreme reliance on direct taxes, and at the Federal level on income taxes, is reflected inordinately in business decisions and judgements. It affects, adversely we believe, entrepreneurial incentives, investment decisions, and the process of capital formation in this

Nation. As a consequence, it raises serious questions regarding our ability to achieve our full potentials for economic growth. An imbalanced system of taxation along with the high tax rates which flow from a progressive income tax system places a large premium on tax "gamesmanship." The risks of distortion in resource allocation because of this fact are great. The economy loses when business decisions are made for tax purposes, rather than for economic reasons. The economy loses when businessmen spend a good portion of their time working on the tax implications of their actions rather than on further accomplishments.

Those of us close to the marketplace daily observe business decisions which are being made in a certain way because of the tax structure rather than sound business judgement. Spending "Uncle Sam's dollars" for advertising, promotion, entertainment, and the like are well-known practices and a concern of taxing authorities. The desire for nontaxable fringe benefits, in lieu of fully taxable cash payments, continues to grow. In our securities business, the 6-month holding period for long-term gains causes many investors to postpone buy-and-sell decisions they might otherwise make. In the more complex areas such as real estate transactions, the distortions are even greater. The costs of such gamesmanship in dollars and opportunities lost is no small affliction to our fiscal health.

We suggest the committee consider this question: How much violence does the imbalance in our tax system do to our ability to form new capital, channel these funds to the most useful purposes, and encourage balanced economic growth? How great a price do we pay for the violence to the business decisionmaking process that occurs because of tax considerations? Although we cannot remove completely the requirements of taxation from business decisions, certainly much can be done to lessen and mitigate their influence.

A study of the above questions in the present environment when no war-type revenue pressures exist is earnestly recommended. Such a dollar-and-cents effort in itself may serve to lend balance to the plethora of proposals aimed at restructuring the tax system for a variety of social purposes emanating from university circles and elsewhere.

A SPECIFIC PROPOSAL

A reduction in the proportion of Federal revenues coming from income taxes would represent a primary and essential improvement in the Federal tax system and do much to insure that the focus of business decisions is on economic rather than fiscal matters. To accomplish this we must increase the revenue from consumption taxes to balance the reduction in the revenue from income taxes.

The optimal way to achieve this end in our view is to supplant the present patchwork system of war-inspired excise taxes with a broad-based Federal excise tax. The tax might take the form of a manufacturer's excise (as advocated by the Business Council in 1959 and 1962), a value-added tax or other broad-based tax on consumption. The broader the base on which this tax is assessed, the better. Exemptions should be kept to a minimum.

Both the administration and Congress have expressed the view recently that major cuts in excise taxes can be expected in 1965. There are good reasons for repeal of the hodgepodge of levies in specific commodities. But we should guard against jumping to the conclusion that the objections to the current network of excise taxes on specific commodities represents a denial of the merits of indirect taxes generally. Any cuts in excise taxes in 1965 will serve to increase even further the proportion of the tax burden flowing from direct taxes on income.

In terms of the longer view of the Federal tax structure which is the concern of this committee, the time is right for a thorough analysis of the need for greater balance in the tax structure. Such study may show that the best answer is not to eliminate excises, but to restructure the system in to a broad-based levy at a low uniform rate. Opportunities to effect such reforms do not come often. We will not take maximum advantage of the opportunity represented by the current interest in excise taxation in 1965, if we do no more than rush to repeal a relative handful of specific excise levies.

The greater use of consumption taxes may be recommended on several counts.

First, the individual is permitted to personally possess and control a greater proportion of the results of his labors and investment. The taxation becomes part of the spending decision and the individual, in a sense, levies it on himself. The recipient determines the time and amount of the tax payment by the spending decision.

Second, thrift and savings are encouraged, for there is no tax on savings funds. Income tax is assessed before savings can take place.

Third, such distribution of the tax load promises a minimum hindrance to economic growth and to consumer and business decisionmaking processes. Taken together with strict control of Federal spending, it promises to produce enough income to support the people and the Government with a minimum reliance on gadgets, gimmicks, or specific controls.

The major objection to excise taxation is that it bears more heavily on people with smaller income than on those with larger incomes. This is so because a higher portion of the larger incomes can be saved, or spent on services which are difficult to reach by excise taxation. The word "regressive" taxation often is used. Although the excise tax used alone is regressive, it does not follow that the use of the excise approach in a system of taxes is open to the same charge. Equity and money flows might be most appropriately assessed in terms of the taxing system as a whole. As long as the system does not impose greater burdens on small incomes, there is no injustice if one part of the system has regressive potentials. Since any single form of taxation will have its imperfections and inequities, there is logic and equity in an approach that balances the progressivity of a tax on income with a tax on consumption that has regressive characteristics. To begin to think in terms of a system of taxation and to assess the system as a whole rather than its individual elements would be a highly desirable advance in fiscal policy thinking.

ARE OUR FEDERAL TAXES CERTAIN AND NOT ARBITRARY?

The Federal tax on income has the merit of a high degree of certainty and for individuals, a minimum of arbitrariness. Although on the corporate level there are greater points of contention, generally speaking, the American income tax system may be accorded a high grade on this count. For our present war-inspired exicse taxes, however, the situation is quite different. Taxes on many commodities falling into the same general class are arbitrary and not necessarily certain. Each exemption under an excise tax produces borderline cases. For example, electric dishwashers are taxable, but electric washing machines are not. Mechanical pencils are taxable, but lead pencils are not. Jewelry made for sale is taxable, but that made as a hobby by an amateur lapidary is not. In our securities field, the differential between taxes on leased wires and on stock quotation or information equipment is arbitrary and unjustified. Admittedly it is more difficult to give a system of excise taxation a degree of certainty equivalent to that possible in an income or gross receipts tax. Certainly, however, a restructuring of the present excise techniques used on the Federal level and the adoption of a broad-based excise with a minimum of exclusions would be less subject to criticism than the present network of excise taxes.

ARE OUR TAXES CONVENIENTLY PAYABLE?

Generally speaking, virtually all American tax systems receive high marks as to the convenience of their payability. With the advent of withholding tax techniques, the escrowing of real estate taxes and other pay-as-you-go schemes, Americans have proved to be masters in making tax payments convenient and as painless as possible. Some feel that the tax payments are so painless that many Americans fail to realize what taxes take from their income. It may well be that without such innovations, taxpayers would view their tax burden in a somewhat different light.

TAXES AFFECTING THE CAPITAL MARKET

Equally important, but of a less general nature, are taxes that directly bear on the efficient operation of the capital market. The Exchange has over the years studied the effects of these taxes on raising capital, transferring securities, and disseminating market information and the resulting impact on economic growth. Presented below are the considered opinions of the exchange on taxation of capital gains, relief from double taxation of corporate earnings, issuance and transfer tax, and the interest equalization tax.

TAXATION OF CAPITAL GAINS

Presently, the law provides that when capital assets are held for a period of over 6 months, one-half of any gains realized from the sale of these assets is subject to regular income tax rates—with the maximum tax set at 25 percent of the total gain. In other words, up to one-quarter of long-term gains is taxed away. Capital gains realized in periods of 6 months or less are taxed as if they were regular income and up to 70 percent of the gain may be taxed away.

The lower individual income tax rates provided in the 1964 Revenue Act has meant some reduction in the effective tax on capital gains for those with a marginal tax rate of less than 50 percent. However, this was only a small part of the relief passed by the House, which was later deleted from the final version of the law, and still leaves a heavy burden on the transfer of capital assets.

Lower tax rate.—The stimulative effect on unlocking of investments and revenue from reducing capital gains rates has been substantiated in an independent study made for the New York Stock Exchange by Louis Harris & Associates, Inc. This survey of investors' buying and selling patterns made several years ago, carefully analyzed the potential revenue effect of a reduced capital gains rate. A major finding was that an inclusion rate of 25 percent (50-percent cut in present tax) would immediately unlock a tremendous amount of capital appreciation and more than double Federal revenues from the capital gains tax. Even after the initial impact, we believe that over the long run the lower tax rate would encourage a high enough volume of transactions to more than offset any revenue loss. The stimulus to the economy and the growth in shareownership would also help to bring about this result.

A further benefit of reducing the inclusion rate is worth pointing out. A 30-percent inclusion like that proposed by the late President Kennedy would go a long way toward correcting the distorting effects of the capital gains tax on price movements. Writing in the National Tax Journal of December 1960, Prof. Harold M. Somers concluded that the capital gains tax "promotes economic instability," because it "accentuates upswings and downswings in security and other asset prices." A lower inclusion rate would lessen the impact of the tax on the price level of securities and thus contribute to a more stable market.

Holding period.—The exchange community, acutely conscious of the need for improving capital mobility, has long urged a 3-month holding period. I repeat that recommendation now.

Let us consider for a moment the philosophy of capital gains taxation. Throughout most of the world, capital gains are not taxed at all, for the simple reason that they are not considered income. In those cases where capital assets are sold regularly in the ordinary course of trade or business, however, a different rule properly applies, both abroad and in this country. Thus, a securities dealer trading in and out on a day-to-day basis would naturally find the profits from these transactions subject to ordinary income tax rates.

The United States, although not exempting capital gains from taxation, at least recognizes that they are different from income and entitled to a differential rate. The holding period is merely an artificial, arbitrary, but administratively convenient and definite, device to distinguish capital transactions from ordinary business transactions. Consequently, the shorter this time period, the less it interferes with the ability of an investor to correct his mistakes or make other appropriate investment decisions.

The present 6 months is unnecessarily long to accomplish its purpose of distinguishing bona fide capital transactions from ordinary business transactions. Studies of the transactions of professional floor traders, active on the New York Stock Exchange, for example, show that 90 percent of their long sales in a sample period consisted of stock purchased within the preceding month. Hence, it can be argued that even a 1-month holding period would serve the purpose.

The exchange believes that the 25-percent maximum long-term capital gains rate should be reduced to 12½ precent. At the same time the long-term holding period should be reduced to 3 months from the present 6 months.

Reducing the penalty on the investor for shifting his stockholdings would provide more efficient use of available capital and result in the following:

> Millions of additional Americans would be encouraged to undertake the risks of shareownership, thus increasing the supply of venture capital available for new and established businesses.
>
> Billions of dollars of "locked in" capital would be released for new and expanding industries.
>
> Tax revenues to the Government could be expected to rise.
>
> The Nation's securities markets would be able to provide investors with greater liquidity and better price stability.

RELIEF FROM DOUBLE TAXATION OF CORPORATE EARNINGS

The 1964 Revenue Act phased out the 4-percent dividend tax credit by reducing it to 2 percent for 1964 and eliminating the credit completely for 1965 and later years. At the same time the $50 dividend exclusion was raised to $100. These two modest provisions enacted in 1954 were originally intended to be a start toward more substantial relief from the double taxation of corporation earnings distributed as dividends. The demise of the 4-percent credit is a step backward in this program.

It should hardly be necessary to debate the question of double taxation. It occurs because corporate earnings are subject first, to a corporate income tax of up to 48 percent. Then the remaining dollars distributed as dividends are taxed again at personal income tax rates. Such treatment is not inflicted on wages, interest, rent, or any other form of income.

The end result is dramatically illustrated in the table below comparing what happens to $1,000 of earnings in a proprietorship and in a corporation. The non-share-owning proprietor in the lowest tax bracket pays a basic 14-percent levy or $140. Out of his $1,000 he nets $860.

The investor, on the other hand, finds the $1,000 has been reduced to $461 after corporate and personal income taxes are paid. Without the $100 exclusion this would fall to $447. This is just a little over half the $860 netted by the proprietor.

Tax burden on $1,000 of additional income from 2 different sources

	Proprietor's income		Corporate income	
Taxable income	$1,000		$1,000	
Business tax	None		480	
Individual receipts		$1,000		$520
Personal tax [1]		140		[2] 59
Net income		860		461

[1] Assuming total individual receipts subject to 14 percent tax rate, after deductions and exemptions.
[2] Allowance made for the $100 dividend exclusion.

Certainly the $100 exclusion alone is inadequate. The 4-percent credit just repealed and the exclusion were enacted as a joint program to provide a partial first step toward relief from double taxation. Repeal of the dividend tax credit distorts the relief from double taxation envisioned in 1954. Nevertheless, the relief is not so partial for millions of stockholders. The $100 exclusion completely eliminates double taxation for an estimated 7,500,000 shareowners and enables them, by and large, to file a simplified tax return. However, to impose full double taxation of dividends above $100 per taxpayer is an expediency that cannot be justified by an consistent economic argument.

Over the years ahead, business will have to raise hundreds of billions of dollars for plant and equipment to meet the needs of an expanding economy. Although reinvestment earnings and borrowing will provide much of the needed money, corporations will nevertheless have to look to the public for a critical portion.

It is here that the tax treatment of equity investors becomes important. How income from an investment is taxed affects the willingness of investors to risk their savings. It is my belief that, even though the 4-percent tax credit and $50 exclusion were only a modest recognition of the need for incentive to risk capital, these provisions did have a positive effect in encouraging equity investment.

To put the matter in proper perspective, let me introduce a bit of history. The original 1954 proposals called for a 10-percent credit and $100 exclusion. Proponents argued that relief on this scale would encourage equity investment. But, it would have been fanciful for anyone to suppose that the modest relief finally enacted could outweigh the advantages of debt or internally generated financing.

There is, however, another way of looking at this question. The relief granted by the credit and exclusion was an incentive to stockholders to supply risk capital for corporate equities. The result was an increase in the potential reservoir of funds available for corporate expansion. It is perhaps too easy to forget that back in mid-1954, when the credit and exclusion were enacted, the Nation's shareowners numbered fewer than 7½ million. In 1962, when our latest census of shareowners was concluded, the total exceeded 17 million—and by all indications has risen since then.

Repeal of the 4 percent dividend tax credit makes it imperative, therefore, that a substitute form of relief be incorporated in our tax laws as soon as possible. The exchange is presently studying the various alternative forms of relief from double taxation—including the dividends paid deduction proposed by the National Association of Manufacturers. Once our studies are completed—probably in the early part of 1965—we shall be able to offer our proposal to Congress.

ISSUANCE AND TRANSFER TAX ON SECURITIES

The Federal tax on the issuance and transfer of securities should be repealed as part of the administration's program of cutting excises. Treasury Secretary Dillon has cited the present structure of excise taxes as a hodgepodge, many of which no longer serve their original purpose but rather increase business costs and are a nuisance to taxpayer and Government alike.

According to expert testimony on the subject presented to the Ways and Means Committee by Prof. John F. Due, "The tax structure should not interfere with efficient functioning of the economic system or with the attainment of economic growth." Levies on the issuance and transfer of securities certainly measure up poorly in this context and should be eliminated.

Issuance tax.—Presently, corporations selling stocks or bonds are subject to a tax based on the proceeds of such sales. This tax has the effect of penalizing corporations for raising money to invest in new job-creating plants and equipment. It is clearly contrary to the goal of economic growth and therefore is objectionable. Further, the levy is of dubious value from the standpoint of revenue production. Yielding only about $10 to $15 million in recent years, the tax nevertheless has an adverse effect on those corporations which finance their expansion through security issues. Such a tax should not be part of our tax system.

Transfer tax.—The tax presently payable on the transfer of stocks and bonds should be repealed. A smoothly functioning securities market, characterized by both liquidity and depth, is essential to the orderly functioning of the Nation's capital market. Transfer taxes, by imposing an added cost on the sale of securities, artificially raises selling prices and adversely affects the market's ability to reflect true values.

Further, on the exchanges, this tax must be paid by "specialists" acting as middlemen in the market. To provide continuity of successive sales prices, specialists enter into many transactions with the public. They buy and sell as the need arises to offset temporary imbalances in the public's supply and demand of stock. Specialists may buy and sell stock many times, even during the same day, to fulfill this responsibility. The Federal tax is nevertheless payable on these transfers where the specialist acts as middleman.

No precise data are available on the revenue yield of the Federal transfer tax. However, an estimate in the range of $35 to $40 million appears reasonable. This is a very small portion of the Federal tax collections. More importantly, the real cost of the tax—in terms of its adverse effect on the capital market, and on the effectiveness of the specialist system—far outweighs its utility as a source of revenue.

Interest equalization tax.—The interest equalization tax finally passed this summer imposes a penalty on purchases of foreign securities from foreigners by U.S. persons for the period from July 19, 1963, to December 31, 1965. Recent statements by members of the administration indicate, however, that the tax might be extended past 1965.

The tax imposes a penalty on debt which varies from 2.75 percent for obligations with a maturity of 3 to 3½ years to 15 percent on obligations with a maturity of 28½ years or more. There is no tax on debt obligations with a maturity of less than 3 years. The penalty on stock is a flat 15 percent.

The Exchange opposed this legislation in both the House and Senate, because the tax was believed not to be in the best interest of the

United States. First, much of our capital outflow has been associated with the increase in our exports during the last few years. Bank loans and acceptance credits have directly financed part of our exports, and foreigners have also used most of the funds they obtained here through security financing to purchase our products. The interest equalization tax has so far not had a major effect on our exports, since the increase in bank loans to foreigners has largely compensated for the decline in security financing from abroad. Nevertheless, the more difficult it is for foreigners to obtain funds here, the more likely that our exports will eventually suffer.

Second, the tax discriminates unfairly against stock issues relative to debt instruments, and therefore weakens or eliminates what has been a favorable flow of funds to the United States. In most recent years, net purchases of U.S. stocks by foreigners exceeded net purchases of foreign stock by U.S. residents, resulting in a capital inflow. For the first 8 months of 1964, however, there has been a capital outflow (in stock transactions) of $43 million—U.S. residents have cut down considerably on their purchases of foreign stocks because of the 15 percent tax, but foreigners have reduced their U.S. purchases even more. Lower foreign purchases, in some cases, reflect the fact that foreigners can buy U.S. securities only with dollars acquired through sales of foreign securities to U.S. residents; reduced U.S. purchases therefore automatically lead to reduced foreign purchases. In other cases, the inability of foreign brokers to sell their stocks to U.S. residents because of the tax has reduced the ability of U.S. brokers to sell U.S. stocks abroad.

Finally, the tax has probably achieved whatever impact it might have on the U.S. capital outflow and on the development of foreign capital markets. Uncertainty about the final features of the tax before its passage held down transactions in foreign securities, but these transactions (or equivalent capital outflows through other means) should increase now that the capital market has adjusted to the tax. Similarly, European borrowers have increased their use of European capital markets considerably during the last year because of the tax. Since those markets have therefore become more sophisticated and more efficient in handling large-scale borrowings, they should continue to play an important role even after the tax expires.

For all these reasons, the Exchange believes that the interest equalization tax should be allowed to expire on December 23, 1965, as originally planned. If the administration finds it necessary to extend the tax, stock should be exempted. In that way the favorable capital inflow previously resulting from transactions in foreign and U.S. stocks may be restored.

SUMMARY

The present system of Federal taxation is found wanting on the basis of equity and its influences on the flow of goods and services through the economy. During the past 25 years, serious imbalances have grown up that thwart incentives, distort business decisions, hinder economic flows, and in all probability retard economic growth.

The biggest single step that could be taken to alleviate present inequities and provide balance for our Federal system of taxes would be to employ broad-based taxes on consumption as a supplement to the present system of income taxation. In terms of timing, the current interest on the part of the administration and the Congress on the subject of excise levies provides a unique opportunity to effect reforms that would be in the long-run interest of the American economy and the efficiency and equity of its system of Federal taxation.

The position of the Exchange on those features of federal taxation closest to its affairs are summarized below:

Reduce the maximum capital gains tax from 25 percent to 12½ percent and shorten the long-term holding period from 6 to 3 months.

Provide an acceptable form of relief from the double taxation of corporate earnings at either the individual or corporate level beyond that presently provided by the $100 exclusion.

Repeal the tax on issuance and transfer of securities.

Permit the interest equalization tax to expire as scheduled on December 31, 1965.

EXHIBIT A

Distribution of tax receipts by type of tax under consolidated cash budget, fiscal year 1963

[In billions]

Type of tax	Consolidated cash budget	Percentage distribution
Individual income taxes	$47.6	45.9
Corporation income taxes	21.6	20.8
Employment taxes	14.9	14.4
Unemployment tax deposits by States	3.0	2.9
Excise taxes	13.2	12.7
Estate and gift taxes	2.2	2.1
Customs duties	1.2	1.2
Total	103.7	100.0

EXHIBIT B

Direct and indirect taxes in 9 countries, 1961 (as percent of total tax yield)

	United States	Canada	France	Germany	Italy	Japan	Netherlands	Sweden	United Kingdom
DIRECT TAXES									
Individual income tax	32.2	19.5	14.7	19.7	11.3	20.3	27.4	52.8	35.5
Corporate income tax	16.3	16.1	6.0	6.9	2.1	26.8	10.4	--------	4.0
Death and gift taxes	1.8	1.5	.7	.2	.7	.5	1.2	.5	3.2
Social insurance contributions of employees	6.7	4.9	6.9	13.5	6.3	6.4	16.2	7.4	7.3
Net wealth tax	--------	--------	--------	1.3	1.4	--------	1.2	--------	--------
Taxes on investment income	--------	--------	1.1	.9	--------	--------	.9	(1)	--------
Taxes on land and building	--------	--------	--------	--------	2.0	--------	1.9	--------	--------
Municipal trade tax	--------	--------	--------	7.5	--------	--------	--------	--------	--------
Other direct taxes	.4	1.2	.4	--------	1.5	(1)	.2	.4	(1)
Total, direct taxes	57.3	43.2	29.8	50.1	25.2	54.0	59.3	61.2	50.0
INDIRECT TAXES									
Excises:									
Alcoholic beverages	3.8	2.2	1.8	1.7	.6	8.3	1.6	6.7	5.3
Tobacco products and matches	2.2	4.1	2.3	3.6	6.8	6.5	3.6	4.1	10.5
Manufacturers' excises	1.8	.2	--------	1.6	.9	3.7	1.2	.9	1.7
Retailers' excises	.3	--------	--------	--------	--------	--------	--------	--------	--------
Motor fuels	4.3	4.2	--------	3.1	7.2	4.6	--------	3.3	6.1
Public utilities	.5	--------	--------	--------	.4	1.3	--------	2.3	--------
Radio, television, phonograph, etc	--------	.1	--------	--------	.7		--------		--------
Stamp duties, registration and transfer taxes, etc	2.0	5.8	3.8	1.0	5.4	2.0	1.6	2.4	1.6
Coffee, tea, and cocoa	--------	--------	.2	.7	.8	--------	--------	.1	--------
Sugar	--------	--------	--------	.2	1.0	.9	.6	--------	--------
Betting and gambling enterprises	--------	--------	--------	.3	1.4	--------	--------	--------	.5
Admissions, entertainment, and amusements	--------	1.3	--------	--------	--------	.5	.2	.2	.1
Other	1.8	.3	2.9	1.3	.9	1.4	--------	1.8	.6
Total, excises	16.7	18.4	11.1	13.3	26.1	29.2	8.9	21.8	26.5
General sales tax	4.0	14.3	25.0	16.5	16.7	--------	13.1	8.3	6.3
Total, excise and general sales	20.7	32.7	36.1	29.8	42.8	29.2	22.0	30.1	32.8
Customs duties	.7	5.6	8.7	2.9	3.7	3.9	7.3	3.7	1.8
Total, excise, sales, and customs	21.4	38.3	44.8	32.7	46.6	33.1	29.3	33.8	34.6
Property taxes	13.2	14.2	1.0	1.6	--------	5.7	.5	--------	9.5
Social insurance contributions of private employers	7.5	4.1	19.3	13.7	27.1	6.0	10.9	4.9	5.9
Other indirect taxes	.6	.3	5.1	1.9	1.2	1.2	--------	.2	--------
Total, indirect taxes	42.7	56.8	70.2	49.9	74.8	46.0	40.7	38.8	50.0
Total, all taxes	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

1 Less than 0.05 percent.

Source: J. A. Stockfisch, U.S. Treasury Department, "International Comparisons on Direct and Indirect Taxes," Excise Tax Compendium, compendium of papers on excise tax structure submitted to the Committee on Ways and Means, 1964, pt. I, pp. 109–181, as reprinted in Joint Economic Committee's "The Federal Tax System: Facts and Problems, 1964," 88th Cong., 2d sess., pp. 10–12.

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