FISCAL ACTIVISM IN THE FEDERAL GOVERNMENT; AN ANALYSIS OF THE REVENUE ACT OF 1964 AND THE REVENUE AND EXPENDITURE CONTROL ACT OF 1968

by

Charles Edward Smith

FISCAL ACTIVISM IN THE FEDERAL GOVERNMENT
AN ANALYSIS OF THE REVENUE ACT OF 1964
AND THE REVENUE AND EXPENDITURE
CONTROL ACT OF 1968

By

Charles Edward Smith

Bachelor of Arts

Bates College, 1963

Thesis Submitted to The George Washington University,
School of Government and Business Administration in
Partial Fulfillment of the Requirements for the
Degree of Master of Business Administration

June, 1969

Thesis Directed by Paul M. Dickie, DBA,
Associate Professor of
Business Administration
The George Washington University,
Washington, D.C.

TABLE OF CONTENTS

LIST OF TABLES

LIST OF ILLUSTRATIONS

CHAPTER I

INTRODUCTION

Walter Heller has remarked that:[1]

> Economics has come of age in the 1960's. Two Presidents have recognized and drawn on modern economics as a source of national strength and Presidential power. Their willingness to use, for the first time, the full range of modern economic tools underlies the unbroken U.S. expansion since early 1961 --an expansion that in its first five years created over seven million new jobs, doubled profits, increased the nation's real output by a third, and closed the $50 billion gap between actual and potential production that plagued the American economy in 1961.

Heller's expression, modern economics, also described as "new economics," is derived from the writings of John Maynard Keynes.[2] Keynes' theory is basically a compromise to the socialist doctrine that proscribed complete governmental control of the economy and the classical, *laissez faire* concept of private economy. His theory provided for direct governmental aid while maintaining private ownership of the economy.

The concept of "modern" economics is a misnomer as far as historical derivation is concerned, but in terms of political practice Heller's use of the phrase is correct. As Heller has indicated, the idea of the Federal government as an active participant in the economy

---

[1]Walter W. Heller, *New Dimensions of Political Economy* (New York: W. W. Norton & Co., Inc., 1967), p. 1.

[2]John Maynard Keynes, *The General Theory of Employment, Interest and Money* (New York: Harcourt, Brace & World, Inc., 1936).

--participation that seeks real growth and stabilization of the economy--commenced with the Kennedy Administration in 1961.

One aspect of this new approach to political economics is the concept of fiscal activism. Prior to the 1960's, Federal fiscal policy was determined by the matching of governmental expenditures with revenues. The impact of the level of expenditures and revenues on the economy was not a prerequisite for a particular fiscal policy. Instead, fiscal policy was a measure of the financial worth of the government. An active fiscal policy, however, is one that is formulated because of its impact on the economy. It is derived not so much to meet the financial needs of the Federal establishment, but to insure that the private economy achieves or maintains a stable growth. If the economy requires stimulation, Federal expenditures must exceed revenues. On the other hand, if the economy were advancing too rapidly and inflation is apparent, revenues must exceed expenditures.

The Revenue Act of 1964, which enacted substantial tax cuts in order to stimulate the economy, and the Revenue and Expenditure Control Act of 1968, which enacted a surcharge on tax liabilities, are examples of fiscal activism. This paper proposes to analyze both of these Acts within a political and economic framework. The Acts will be traced from conception to enactment, and to the subsequent effect that they had on the economy.

The analysis will include the following:

1. The political problems that arose as the government attempted to become an active participant in the private economy; more specifically, the political problems associated with increasing the Federal deficit at a time when it was at an all time high, as was the case in 1963;

2. The economic theory of fiscal activism or the "new economics";

3. A comparison of the Revenue Act of 1964 and the Revenue and Expenditure Control Act of 1968;

4. The political and economic significance of the relationship of unemployment to inflation.

CHAPTER II

THE EISENHOWER YEARS--THE ELEVENTH HOUR OF FISCAL ORTHODOXY

In 1958 unemployment in the civilian labor force was 6.8 per cent.[1] The economy was suffering its third recession since the end of World War II. This recession, although not serious in terms of productivity, by employment measures was the worst. The economy had not performed so poorly since the 1930's when unemployment ranged from 15 to 20 per cent.

Even though the unemployment total was in excess of 4.6 million, the enemy of economic growth was not unemployment but inflation--or so it seemed to the President, his advisors, and a majority of Congressmen and Senators. In June of 1958 Senator Paul Douglas (D-Illinois), after eloquently reminding the Senate that government had pledged itself to provide maximum employment by the Employment Act of 1946, requested an immediate tax cut of six billion as the quickest way to alleviate the unemployment problem. His resolution was, however, soundly defeated, 65-23.[2] The majority believed that it would be "fiscally irresponsible" to reduce taxes when the budget was already incurring a deficit.

Yet less than six years later, seventy-seven Senators cast their support for a tax cut almost twice as large, one that was not temporary,

---

[1]National Industrial Conference Board, Economic Almanac (New York: MacMillan Company, 1967), p. 27.

[2]U.S., Congressional Record, 1958, CIV (June 18), 11574.

[illegible]

and at a time when unemployment was less than in 1958. It was an unprecedented action. In the political passing of those six years the role of government in the management of the economy changed from that of a passive agent that acted to prevent excess maladjustments to an active participant, able and willing to use almost every economic weapon at its disposal to insure dynamic growth and prosperity.

In the politicians' lexicon unemployment is often exchanged with inflation as "the" vote getter. Since the elections of the 1930's few politicians have doubted the efficacy of unemployment as a political issue. After World War II, through the presidential election of 1952, inflation captured the politicians' imagination. After 1952, however, unemployment returned to the center of the political arena. It became the crucial economic issue. In the recessions of 1953-54 and 1957-58 unemployment rose sharply above its previous levels. This was also accompanied by a fear of eventual unemployment among many that were still employed.

The political debate that ensued--Democrats accusing Republicans of "callousness" toward unemployment, and Republicans accusing Democrats of profligacy--carried on into the presidential election of 1960. As in any collegiate debate, this one had an ephemeral victor--the Democrats on the side of fiscal activism. From the Democrats a new political/economic policy emerged, that of the "new economics." It was a marriage of Keynesian theory, classical doctrine, and modern public administration. Its fruition was the Revenue Act of 1964 and the Revenue and Expenditure Control Act of 1968.

In order to understand the importance of this change in political economics and the resulting fiscal activism, the clock must be turned

back to the Eisenhower years--the years of fiscal orthodoxy--and proceed with an analysis of one of the most significant economic debates of modern times.

The landslide election of 1952 provided a presidential mandate to Dwight D. Eisenhower. This mandate included, among other things, an authority to practice fiscal orthodoxy--an orthodoxy that to Eisenhower meant a reduction in governmental taxes and spending which would create a balanced budget and an end to an inflation that had been politically associated with Democratic economic policy. Eisenhower has stated that, "I put myself on record as an enemy of inflation and expressed conviction that excessive taxation could destroy the incentive to excel."[1] After he assumed the office of President, he said, "There was no one among my immediate associates not dedicated, in principle, to the proposition that both Federal expenditures and the public debt must be reduced."[2]

The end of the Korean hostilities provided the means to start reducing governmental expenditures as a beginning toward eventual tax cuts. Although some people warned that a recession could result from such a policy, the Administration was committed to the policy of curbing inflation and, accordingly, ordered a sharp reduction in military expenditures. As a few had predicted, the economy entered into its second recession since World War II.

There is widespread agreement that the cause of the 1953-54 recession was the reduction in military expenditures. Eisenhower, himself, has reflected that, "The contraction, in part, represented the

---

[1]Dwight D. Eisenhower, Mandate for Change (New York: Doubleday and Co., 1963), p. 33.

[2]*Ibid*., p. 127.

efforts of businessmen to reduce inventories, and was aggravated by a large reduction in military expenditures."[1] Economist Alvin H. Hansen has written that, "The recession . . . was due almost entirely to the drop in government expenditures incident to the cessation of the Korean conflict. The decline in governmental outlays . . . in real terms amounted to $10.9 billion."[2] In a Brookings Institution study, Bert G. Hickman concluded that, " . . . the cutback in Federal expenditures was the major deflationary force acting throughout the contraction."[3] Hickman computed the drop in Federal spending at $12 billion between the second quarters of 1953 and 1954. Sherman Adams, advisor to President Eisenhower, however, felt that credit policy was a major cause. "The public finger was pointed at George Humphrey's [Secretary of the Treasury] attempt to tighten credit . . . a little too much . . . . The crisis passed, but it left its mark as an error in Humphrey's fiscal calculations."[4]

The actual decline began in the middle of 1953. The Treasury and the Federal Reserve System had already taken steps to ease credit in May by embarking on an extensive open market operation, and again in June by lowering the reserve requirement of FED member banks. The Council of Economic Advisors' Chairman, Arthur F. Burns, advised the cabinet that some planning should be undertaken as a precaution against

---

[1]U.S., President, Economic Report of the President, 1955 (Washington, D.C.: Government Printing Office, 1955), p. iv.

[2]James Tobin, ed., Economic Issues of the '60's (Boston, Mass.: McGraw Hill Co., 1960), p.146.

[3]Bert G. Hickman, Growth and Stability of the Postwar Economy (Washington, D.C.: Brookings Institution, 1960), p. 99.

[4]Sherman Adams, Firsthand Report (New York: Harper & Co., 1961), p. 161.

further decline. At this point, Eisenhower quickly abandoned his thoughts of fiscal orthodoxy. At a news conference in November of 1953, when asked about the possibility of a recession, he replied that, "When it becomes clear that the Government has to step in, as far as I am concerned, the full power of Government, of Government credit, and of everything the Government has, will move in to see that there is no widespread unemployment."[1]

By early 1954, unemployment had risen to 5.8 per cent. Two million more persons were unemployed than that of the previous year. Sherman Adams and Robert Donovan, in their accounts of this period, both portray the Administration as being ever-watchful over the economic indicators. While intensive planning was going on under the supervision of CEA Chairman Burns, Adams describes Eisenhower as "ready to launch a public works program to ease unemployment if the emergency became dangerous."[2] Donovan saw a "striking picture of a President and his Government grappling with trouble in a vast, complicated economy."[3]

Despite Eisenhower's promise of an all-out effort if necessary, the Administration took a cautious view of heavy-handed fiscal action. Instead, attempts to curb the downturn were more of a structural nature. The temporary income and excess profits tax that had been levied during the Korean Conflict, already scheduled to expire on 31 December 1954, was allowed to expire. The President also recommended a broad program of legislation which included tax proposals designed to stimulate business

---

[1]U.S., President, Public Papers of the President, 1953 (Washington, D.C.: Government Printing Office, 1954), p. 785.

[2]Adams, Firsthand Report, p. 162.

[3]Robert J. Donovan, Eisenhower, The Inside Story (New York: Harper & Co., Inc., 1956), p. 209.

enterprise; e.g., liberalized depreciation allowance on new investments, fuller treatment of research and development outlays as current expenses, and partial tax credits to recipients of dividends for the income taxes already paid by corporations. Other beneficial legislation included expanding the scope and raising of the benefits provided by the old-age and unemployment insurance system, extending and liberalizing credit facilities for home ownership, and improving the nation's highways. Congress gradually enacted many of these proposals and also added a sizable cut in excise taxes, which, after allowing for an increase of $1.3 billion in social security contributions, brought the various tax reductions for individuals and businesses that became effective in 1954 to $6.1 billion.[1]

Other action was taken in addition to the steps outlined above. As in the middle of 1953, the FED lowered the discount rate and the reserve requirement rate of member banks in early 1954. Governmental subsidies were given to some hard-pressed industries, such as shipbuilding through a new construction program, and to zinc and lead mining through a revised stockpiling program. The government made an effort to assist depressed areas of the country by channeling governmental contracts to them and by boosting the allowable rate of accelerated amortization on such industrial investments in these areas in order that the nation's defense base might be strengthened. Administrative activities were carefully watched with an eye toward greater efficiency and toward meeting the immediate needs of the economy. The Veterans Administration speeded up the processing of loan guaranty applications

---

[1]Arthur F. Burns, Prosperity Without Inflation (Garden City, N.Y.: Doubleday and Co., 1958), p. 32.

for loan insurance. The Department of Agriculture expedited arrangements to stimulate private construction of grain elevators. The Internal Revenue Service made advance payments to taxpayers who had been over-assessed prior to the final determination of their over-assessment. The Bureau of Public Roads lost no time in implementing its expanded financial authority.[1]

Although no massive spending programs were launched, the Administration attempted to halt the decline in governmental expenditure, which, in the case of the Department of Defense, had been greater than was originally planned or anticipated. A modest re-scheduling of expenditures within the total set for fiscal year 1955 was adopted with a view toward raising the government's planned spending for the first six months and thus reinforcing the economic recovery.[2]

CEA Chairman Burns has concluded that the Administration's effort to combat recession did not include a pre-planned strategy and such a strategy, if it had existed, would more than likely have failed.

> These actions to curb the decline of economic activity did not express the unfolding of any master plan in which all details had been worked out in advance and every contingency provided for. Not only is this sort of theory practically impossible, but any determined attempt to realize it could invite disaster. No two recessions ever run the same course; unforeseen developments are bound to occur; and measures that work well in one situation may work badly in another. A wise government will therefore seek to maintain flexibility in its approach and be prepared to do more in one direction and less in another, besides trying new measures. It will not entrust the nation's fate to a categorical economic forecast or to a rigid economic program.[3]

There was little public mention of the recession by the Administration, especially in regard to the planning that had been taken to

---

[1]Ibid.

[2]U.S., President, Economic Report of the President, 1955, pp. 69-71.

[3]Burns, Prosperity Without Inflation, p. 33.

fight the recession. In fact, Eisenhower was publicly loath to mention that the recession was enough to warrant concern. In the 1954 Economic Report of the President, Eisenhower acknowledged a "slight contraction in business" and predicted that there would be no "serious interruption" of economic growth.[1] In April of 1954, Eisenhower, in a television speech, stated that he was concerned about the widespread talk of unemployment and he was not considering any strong pump-priming action until it was absolutely necessary.[2] In a news conference in May he was asked to comment about a quote by Sumner Schlichter, a Harvard economist, to the effect that the Administration had shown a "surprising lack of initiative and enterprise" in fighting the recession. Eisenhower casually replied (it would seem) by referring such questions to "the Chief of my Economic Advisors for his side of the story."[3]

Republican Congressmen were somewhat more critical of Democratic claims of inaction. Joseph W. Martin, Jr. (R-Massachusetts), the House Speaker, led critical attacks on the "left wing eggheads" that were attempting to "yell the country into a recession."[4] At one point, even a Communist "red herring" was dragged across the economic debate. Charles G. Oakman (R-Michigan) said, "We do know that there are those within our shores who are happy at any time to do the bidding of their Russian Masters."[5]

---

[1]U.S., President, Economic Report of the President, 1954 (Washington, D.C.: Government Printing Office, 1954), pp. iv-v.

[2]U.S., President, Public Papers of the President, 1954, p. 380.

[3]Ibid., pp. 529-30.

[4]U.S., Congressional Record, 1954, C, (January 20-28), 563.

[5]Ibid., (February 25), 2280.

For their own part, while quick to criticize the Republican Administration, the Democrats did not develop any substantive anti-recession program. Individual Senators and Congressmen advocated a myriad of suggestions such as expanded public works, tax reductions, cheaper money, enlarged social security, and anti-monopoly measures. There was, however, little effort made to collect these voices into anything that resembled an alternative program. The advocacy of a $5 billion tax cut by some of the Democratic members of the Joint Economic Committee under the leadership of Paul Douglas (D-Illinois) was the nearest thing to a party policy that emerged in 1954.

This is not to say that the Democrats did not develop a campaign issue during the Congressional elections of 1954. That issue centered around the Republican Administration's attitude toward the whole gamut of economic responsibility to the nation. Adlai Stevenson summated this issue during the closing days of the campaign: " . . . the election of a Democratic Congress on Tuesday . . . will chasten the Administration's complacent attitude toward the millions of Americans who cannot find jobs."[1]

The Democrats were successful in the 1954 Congressional election to the extent that they won control of both Houses of Congress by a margin, which indicated that the issue of unemployment was a factor in "chastening" the Administration. Statistical studies conducted by James L. Sundquist for a Brookings Institution study, while not proving conclusively that unemployment or the fear of unemployment was the principal cause for the shift in voter preference, do, however, indicate

---

[1]Adlai Stevenson, "What I Think," Harper's, October, 1956, p. 92.

that there was a high degree of correlation between the timing of voter switching with the high unemployment mark during 1954.

> . . . The decisive swing in voter preference that resulted in the restoration of Democratic control of Congress occurred when the recession struck in the winter [as supported by Sundquist's and other statistical surveys], and that the voters whose loyalties were then switched remained on the Democratic side.[1]

The second recession of the 1950's occurred by happenstance at the same time as the mid-term Congressional election of 1958. The 1957-58 recession was greater, albeit shorter, than that of 1953-54. The seasonally adjusted percentage of unemployment in October 1957 was 4.7 per cent of the labor force. By February, 1958, that figure had risen to 6.7 per cent.[2] Perhaps the unadjusted rate of unemployment for this period is more indicative of the hardships that can cause political reaction. Between October, 1957, and February, 1958, unemployment more than doubled. The numbers of unemployed in February exceeded five million, the largest since the 1930's. The February unadjusted rate was 7.7 per cent.[3]

The Democrats again pursued the issue of recession and Republican inadequacies. There was some feeling among Democrats and businessmen that the recession had actually been planned so as to achieve price stability to ward off inflation. The following appeared in <u>Time</u> magazine:

> Many businessmen received the dip at year's end [1957] without alarm because they regarded it as a "recession as planned." . . . Though no one wants unemployment, coldly

---

[1]James L. Sundquist, <u>Politics and Policy</u> (Washington, D.C.: Brookings Institution, 1968), p. 441.

[2]N.I.C.B., <u>Economic Almanac</u>, 1967, p. 27.

[3]<u>Ibid.</u>, p. 44.

> statistical economists can find some virtue in it, expect the U.S. to benefit through increased productivity . . . Moreover, as jobs grow scarcer, wages will flatten out.[1]

Congressman John A. Carroll (D-Colorado) quoted William McChesney Martin, Jr., FED Chairman, as saying that the recession was "deeper and sharper" than had been "anticipated."[2] Senator Hubert H. Humphrey (D-Minnesota) remarked on the Senate floor that, "The Administration's recession blueprint has come into full flower . . . I trust that the Republican Party is pleased at its success. I hope the Administration continues to sit on its collective hands."[3]

The Administration continued to follow the policy that they believed brought success in 1954. The government's economists did not believe that the economy needed a boost. To them, the new recession would be a repeat of 1953-54 and would quickly end. They wanted to avoid what in 1954 Eisenhower had called "slambang emergency programs." The Administration was to again give appearances of cool appraisal of the economic situation. Anything other than that would be injurious to the public confidence that was necessary to restore the economy.

To compound the Administration's problems, Eisenhower had encountered in 1957 what was to him an even more perfidious enemy --inflation. The Administration was very doubtful about the efficacy of an active fiscal policy as remedial action to a depressed economy if that policy created the seminal beginnings of inflation. At a February, 1958, news conference, Eisenhower was asked about a possible tax cut. He responded that it would be a stimulus to the economy; but he added,

---

[1]"Nation's Business," Time, December 30, 1957, pp. 53, 55.

[2]U.S., Congressional Record, 1958, CIV, (February 5), 1957.

[3]Ibid., (March 6), 3578-83.

" . . . this is something you can take hold of and, going too far with trying to fool with our economy, then you get something else started. And you just remember, all of you here a year ago, how we were always talking about inflation and the things we were trying to study."[1]

As if on cue, the Democrats responded with a rash of economio programs as widespread as the ones of 1954--public works, tax reduction, increases in minimum wages, expanded unemployment insurance, liberalized housing credit, farm price support, etc. As in 1954, these individual programs did not create an alternative policy. Many Democrats, however, convinoed Senate Majority Leader Lyndon B. Johnson (D-Texas) to develop a Democratic policy. This was done and was accordingly introduced to the Senate in March, 1958. The policy amounted to a resolution for the Administration to speed up certain civilian and military expenditures within the limits of existing authority and appropriations. There was a great amount of political in-fighting as a result of this resolution; the Administration believed that they were doing everything possible, including accelerated expenditures, and was affronted by the Democratic resolution. In a short time, this quarrel was ended by an addition to the resolution commending the Administration for its continuing efforts in fighting recession; the resolution passed both Houses with little more debate.

It was at this time that a new force began to enter into this political-economic arena; fiscal activists, both inside and outside of Congress, concentrated their efforts upon tax reduction as the most effective means of stimulating the economy. Political leadership for

---

[1]U.S., President, Public Papers of the President, 1958 (Washington, D.C.: Government Printing Office, 1959), p. 147.

this cause centered with a former economics professor, Senator Paul Douglas. He argued that a public works program of large expenditures efficiently conceived and executed would still be too slow to stimulate the economy. Over a period of five months, he presented his arguments for a temporary tax cut and support for his ideas gradually increased. The Democratic Advisory Council endorsed the idea in April, 1958. This endorsement was followed by a similar endorsement from the prestigious Committee for Economic Development. The U.S. Chamber of Commerce, the President of General Motors, Chairman of the Board of J. P. Morgan and Company, AFL-CIO President, Budget Director Percival F. Brundage, and CEA Chairman Burns all added their support to the tax cut.[1] Former FED Board member Mariner S. Eccles, appearing before the Senate Finance Committee in April, presented an argument for the tax cut that would become the logic for a similar request six years later:

> If recovery can be hastened by a tax reduction, and I believe it can, it is reasonable to expect that even lower tax rates will soon be offset by the growth in the national income. Therefore, a balanced budget could be achieved through such recovery, whereas with higher tax rates and a depressed economy, the Government revenue would be diminished and a balanced budget impossible. I believe the Government deficit over the next two years, and hence the public debt, will be less if an adequate tax-reduction program is promptly adopted than would be the case if the country had to wait for the stimulating effect of increased Government spending.[2]

The tax cut bill that Senator Douglas introduced in March amounted to a $5.2 billion reduction that was divided between personal income and excise taxes. The ensuing debate over the tax cut bill was involved and at times acrimonious.

---

[1]U.S., Congressional Record, 1958 (as quoted on Jan. 28, Aug. 4, March 11), 11597, 15980-82, 3898-3901.

[2]U.S., Congress, Senate, Finance Committee, Hearings, Investigations of the Financial Conditions of the United States, 85th Cong., 2nd Sess., 1958, pp. 4274-4302.

> Senator John J. WILLIAMS, (R-Delaware): I do not believe a tax reduction should be financed with borrowed money . . . A government cannot spend itself into prosperity any more than can an individual.
>
> Senator Charles E. POTTER, (D-Michigan): It is rather hard to get the people of Michigan concerned about inflation when 350,000 of the people of Michigan are unemployed.
>
> WILLIAMS: But a tax reduction is not what they want. What those men want are jobs . . . .
>
> POTTER: But the tax reduction will put the economic machine back into operation, and in that way jobs will be provided.
>
> WILLIAMS: No good will be done if the solvency of the Government is destroyed.[1]

At the end of the debating, not unlike this, the bill was defeated, 71-14.

Senator Douglas tried another tax cut bill in June for the amount of $6 billion. He again was defeated, 65-23. There is some speculation that one of the reasons for the inability of the Democratic Senators to rally behind Douglas is because of an agreement reached between Speaker Samuel Rayburn, Majority Leader Lyndon Johnson, and Secretary of the Treasury Robert Anderson. The agreement was that neither side would try to gain political advantage over the other by independently pushing for the tax bill. Eisenhower indicated at a news conference in early April that the three would consult together before any tax cut would be introduced in Congress.[2]

The importance of the three-way agreement of prior consultation may have been that the Democratic two-thirds of the group, while ostensibly reflecting bi-partisan unity over such a serious issue, may have instead felt that if anyone should get in political trouble because

---

[1]U.S., Congressional Record, 1958, 4285-87.

[2]U.S., President, Public Papers of the President, 1958, p. 294.

of the miscalculated effects of a tax cut, it should be the Administration.[1] At any rate, the support for Douglas never materialized. As if by some magical machine capable of turning back the clock to 1954, the 1957-58 recession turned into recovery in the Spring of 1958. The recession had been brief and after it had bottomed out, the recovery was swift. The spending and credit measures had taken effect and Eisenhower noted that, "the storm was over."[2] By the measure of unemployment, the "storm" had been worse than the one in 1954. Unemployment in October, 1958, adjusted for seasonal variation, was 7.1 per cent.[3] The November Congressional elections resulted in a buildup of Democratic control over both Houses; they gained a net total of thirteen seats in the Senate and forty-seven in the House. As in 1954, unemployment and the recession were not the sole issues of the campaign. Eisenhower and many others, however, rate them as a principal factor in the Republican losses.[4,5]

With the election of 1958 out of the way and the economy on the road to recovery, the Administration returned to the more orthodox theories of fiscal policy. Inflation became the target for governmental activity. The fiscal year 1960 budget was a balanced budget and it included a $4 billion reduction in expenditures. Eisenhower has since written that some of his advisors argued against so soon a return to a

---

[1]Sundquist, Politics and Policy, p. 27.

[2]Dwight D. Eisenhower, Waging Peace (Garden City, N.Y.: Doubleday & Co., 1965), p. 310.

[3]N.I.C.B., Economic Almanac, p. 46.

[4]Eisenhower, Waging Peace, p. 310.

[5]Sundquist, Politics and Policy, pp. 456-62.

balanced budget; but the important consideration then was a deteriorating balance of payments situation and the need to strengthen the confidence that foreign bankers held in the dollar.[1]

The economic events of 1959 proved that success in dealing with recessions was not a reality. Although production did rise, and rise rapidly, the last half of 1958 and the first half of 1959, employment did not. Throughout 1959, unemployment remained at 5.5 per cent.[2] In some industries, such as steel, production had spurted ahead without a sizable reduction of unemployed steel workers.

The remainder of the Eisenhower years evidences an increase in his determination to represent fiscal "integrity." His budget was balanced. He wanted Presidential authority to veto specific sections of appropriations bills. He sought to have price stability included as a specific goal of the Employment Act of 1946. Vice-President Nixon was designated as head of a Cabinet committee on price stability. Many expenditure bills sent to him by the heavily Democratic Congress were vetoed. It was with this ideology that the Republicans entered the 1960 Presidential campaign.

A most devastating blow fell to fiscal orthodoxy in March, 1959. The Joint Economic Committee under Chairman Douglas prepared a report that stated that the majority of the Committee believed that the inflation so readily pursued by the Administration hardly existed.

> The consensus of the expert testimony presented to the committee in its hearings . . . was that substantial stability in the price level will probably require less emphasis in Federal economic policies in 1959 than the other objectives of

---

[1]Eisenhower, Waging Peace, p. 385.

[2]N.I.C.B., Economic Almanac, p. 74.

> the Employment Act. . . . Since early 1958 . . . a high degree of stability in prices overall has been achieved.
>
> Examination of the facts belies the widespread impression that the economy has been persistently plagued since the end of the war with "classical" inflationary pressures. . . . Until evidence of an imminent inflationary threat can clearly be seen . . . a reasonable and sane policy aimed at promoting maximum employment and production and vigorous expansion of the economy should not be unduly deterred by the possibility of future inflation.
>
> On the basis of the present economic outlook, principal emphasis in public policy this year should be placed on prompt and full recovery from the 1957-58 recession.[1]

The minority Republican report, however, stressed the perils of inflation. " . . . [It is now] the gravest potential obstacle to the achievement of high and rising rates of economic growth and improvement."[2]

The Joint Economic Committee then turned to the preparation of another report, Employment, Growth, and Price Levels. An extensive report, this study was to eventually become the cornerstone of the Democratic policy platform in 1960.

The Democratic charges of Republican mismanagement and slow economic growth were reinforced by another small recession in 1960. It was the third recession in six years. It appears to have been enough to return the Democrats to the Executive Branch of the Government.[3,4] An opinion by Robert Lekachman summates succinctly the Republican

---

[1]U.S., Congress, Joint Economic Committee, Report of the Joint Economic Committee on the January 1959 Economic Report of the President, 86th Cong., 1st Sess., 1959, pp. 2-3.

[2]Ibid., pp. 33-34.

[3]Sundquist, Politics and Policy, pp. 463-66.

[4]Theodore C. Sorenson, Kennedy (New York: Harper and Row, 1965), p. 217.

dilemma:

> By the criteria of the Employment Act of 1946, by the principles of public finance, the Republican economic policy was a failure. In 1960 the party paid the appropriate electoral price.[1]

---

[1]Robert Lekachman, The Age of Keynes (New York: Random House, 1966), p. 225.

CHAPTER III

THE REVENUE ACT OF 1964

The new President, John F. Kennedy, entered office with a dismal appraisal of the economy.

> We take office in the wake of seven months of recession, three and one-half years of slack, seven years of diminished economic growth. . . . Our recovery from the 1958 recession, moreover, was anemic and incomplete. Our Gross National Product never regained its full potential. Unemployment never returned to normal levels. Maximum use of our national industrial capacity was never restored. This Administration does not intend to stand helplessly by . . . .[1]

Despite the forcefulness of those words, they belied the Administration's early attempts to foster economic growth. Kennedy's initial steps to combat the fourth postwar recession were in many ways identical to his predecessor. Authorized spending was accelerated, temporary extensions of unemployment benefits were sought, and a tax reform measure was requested to stimulate investment. A tax cut, however, was rejected until the situation approached more urgent proportions.[2]

The economists who favored an active fiscal policy and who also were practitioners of the Keynesian school of economic thought were now inside the government. Kennedy had selected Walter Heller as his CEA Chairman; the other Council members selected were James Tobin and Kermit Gordon, all proponents of the "new economics." Kennedy, himself, also

---

[1]U.S., President, Public Papers of the President, 1961 (Washington, D.C.: Government Printing Office, 1962), pp. 19-20, State of the Union Message.

[2]*Ibid.*, pp. 32-33.

[illegible]

came under the counsel of such liberal non-government economists as Seymour Harris of Harvard and Paul Samuelson of M.I.T. All of these men gradually generated an influence with the new President. This was no little effort. According to Harris' and Heller's accounts of this period, Kennedy was not easily convinced of the exact role of fiscal activism envisaged by his economists.[1] Especially consistent and persistent in his views, Heller probably exerted the most economic influence on the President. Theodore Sorenson has written that the Council kept the President "buried under a tide of memoranda. They became the most highly influential and frequently consulted Council of Economic Advisors in history."[2]

Heller has written that:

> President Kennedy's occasional doubts and concessions to prevailing economic sentiment stand out only as detours on his road to modernism. What was pleasing to his economic advisors, and fortunate for the country, was his responsiveness to analysis, the force of economic logic and fact; to analogy, the demonstrated success of Keynesian policies abroad; and to anomaly, the continued sacrifice of human and material resources on the altar of false concepts of "sound finance."[3]

The acceptance by Kennedy of the tenets of the new economics was a slow process requiring over two years. The political realities of the times, the Berlin Crisis of 1961, and the question of a tax increase to meet international commitments, and a recovering economy, created an intransigence in Congress against the unorthodox methods of fiscal policy.

---

[1]Seymour H. Harris, The Economics of the Kennedy Years (New York: Harper and Row, 1964), pp. 24-27. Walter W. Heller, New Dimensions.

[2]Theodore H. Sorenson, Kennedy (New York: Harper and Row, 1965), p. 264.

[3]Heller, New Dimensions, p. 35.

In June of 1962, the recovering economy faltered. Also in June, Kennedy delivered his famous Yale speech where he attacked the "myths" concerning the national economy, pointing out that Federal deficits create inflation and budget surpluses prevent it. Yet, even after this public display of the perils of fiscal orthodoxy, Kennedy was not prepared to follow up with a request for a tax cut. Heller considers December of 1962 as the low point in Kennedy's determination to follow through on a tax cut. The cabinet had strongly opposed it in favor of increased public expenditures. Also, John Kenneth Galbraith, an economist of whom Kennedy thought highly, had argued to the President that increased public expenditures in poverty programs was the correct way to influence the economy. Kennedy's enthusiasm for the tax cut was to return, however, after his highly successful speech to the Economic Club of New York that same month.[1] This speech contained the first public explanation by the President of why a tax cut was necessary:

> The final and best means of strengthening demand among consumers and businesses is to reduce the burden on private income and the deterrents to private initiative which are imposed by our present tax system. . . .
>
> I am talking about the accumulated evidence of the last five years, that our present tax system, developed as it was, in good part, during World War II to restrain growth, exerts too heavy a drag on growth in peacetime; that it siphons out of the private economy too large a share of personal and business purchasing power; that it reduces the financial incentives for personal effort, investment, and risk-taking.
>
> Any new tax legislation enacted next year should meet the following three tests: First, it should reduce net taxes by a sufficiently large amount to do the job required. . . . Too large a tax cut, of course, could result in inflation and insufficient future revenue--but the greater danger is a tax cut too little or too late to be effective.

---

[1] Ibid., pp. 34-35.

> Second, the new tax bill must increase private consumption as well as investment. . . .
>
> Third, the new tax bill should improve both the equity and simplicity of our present system. This means the enactment of long needed tax reforms, a broadening of the tax base and the elimination or modification of many special tax privileges.
>
> Our true choice is not between tax reduction, on the one hand, and the avoidance of large Federal deficits on the other. It is increasingly clear that no matter what party is in power, so long as our national security needs keep rising, an economy hampered by restrictive tax rates will never produce enough revenue to balance our budget just as it will never produce enough jobs or enough profits. Surely the lesson of the last decade is that budget deficits are not caused by wild-eyed spenders, but by slow economic growth and periodic recessions, and any new recession would break all deficit records.
>
> In short, it is a paradoxical truth that tax rates are too high today and tax revenues are too low, and the soundest way to raise revenues in the long run is to cut taxes now. The experience of a number of European countries and Japan have borne this out. And the reason is that only full employment can balance the budget, and tax reduction can pave the way to that employment. The purpose of cutting taxes now is not to incur a budget deficit, but to achieve the more prosperous, expanding economy which can bring a budget surplus.[1]

If the Administration was convinced that a tax cut was needed in 1963, some influential Congressmen were not. The following excerpts from a news magazine are remarks made by Congressman Wilbur Mills (D-Arkansas), Chairman of the Ways and Means Committee:

> There probably will not be a deterioration [in the economy] during the early part of 1963. On the basis of that projection . . . there would seem little justification for a "quickie" tax cut effective Jan. 1, 1963. . . .
>
> I cannot go along with the idea that you just cut taxes without regard to the deficit that is created. . . .
>
> I doubt that you could sell a tax cut alone for purposes of trying to do something to the economy until it's generally discernible that a downturn is coming. . . .[2]

---

[1]U.S., President, <u>Public Papers of the President, 1962</u>, pp. 877-80.

[2]"Why a Tax Cut is Unlikely in '63," <u>U.S. News and World Report</u>, December 17, 1962, pp. 42-45.

To the average citizen the prospects of a tax cut would seem to be inherently appealing. This idea, however, had to counter with the popular belief in the necessity of a balanced budget. The concept that individuals cannot increase their prosperity by deficit spending was likewise true for governmental budgeting was deeply entrenched in the public mind as good economic theory and also as a moral precept. A major educational requirement became obvious. The public had to be convinced that they should not only accept a tax cut and, therefore, increased income with equanamity, but also regard the resulting short term budget deficit as a non-value essential for an ultimate full employment economy.

The Administration put great emphasis on its educational efforts. The support of business was sought and received. The U.S. Chamber of Commerce, the National Association of Manufacturers, the American Bankers Association, and the New York Stock Exchange are just a few of the prestigious associations that lent their support to the tax cut.[1] For technical support, the Administration received the endorsement of 400 economists who agreed with the theory and the timing. The most important convert, however, was Wilbur Mills, without whose support a tax reduction bill would have died a slow death in committee. Sorenson reflects that,

> Slowly the President brought him around. Initially Mills agreed to a major tax reform bill, with a little tax reduction to help it along. When presented, it was a tax reform and tax reduction bill. In testimony, it became a tax reduction and tax reform bill. And when it was reported out by Mills, the President had

---

[1]The support from these associations as well as that from the economists was, in the main, theoretical support. In later testimony at Mills' committee hearings many of these associations and individuals took exception to specific proposals in the recommended bill.

his major tax cut bill with a little tax reform.[1]

The original request for tax reform and tax reduction was submitted to Congress by the President under the title, "Revisions of our Tax Structure," on January 24, 1963. After an introduction similar in content to Kennedy's Economic Club of New York speech, the following was proposed:

1. Reduction in individual income tax rates from the present levels of 20 to 91 per cent, to a range of 14 to 65 per cent;

2. Reduction in the rate of the Corporate income tax from 52 per cent to 47 per cent;

3. Reversal of the Corporate normal and surtax rate so that the tax rate applicable to the first $25,000 of corporate income would drop from 30 to 22 per cent, so as to give particular encouragement to small businessmen;

4. Acceleration of tax payments by corporations with anticipated tax liabilities of more than $100,000 to bring the corporate payment schedule to a current basis over a five year period;

5. Revision of the tax treatment of capital gains, designed to provide a freer and fuller flow of capital funds and to provide a greater equity;

6. Removal of certain inequities and hardships in the present tax structure; and

7. Broadening the tax base of the individual and corporate income taxes to remove unwarranted special privileges, correct defects in the tax law, and provide more equal treatment of taxpayers--thereby permitting a larger reduction in tax rates than would otherwise be

---

[1]Sorenson, Kennedy, p. 432.

possible, and making possible the proposal to alleviate hardships and inequities.[1]

Enactment of this program, according to the President's message, would strengthen every segment of the national economy while at the same time bring to fruition the goals of the Employment Act of 1946.

> Total output and economic growth will be stepped up by an amount several times as great as the tax cut itself. Total income will rise--billions of dollars more will be earned each year in profits and wages. Investment and productivity improvement will be spurred on by more intensive use of present productive potential; and the added incentives to risk-taking will speed the modernization of American industry. Additional dollars spent by consumers or invested by producers will lead to more jobs, more plant capacity, more markets, and thus still more dollars for consumption and investment. Idle manpower and plant capacity make this possible without inflation; and strong and healthy economic activity is the best insurance against future recession.
>
> Unemployment will be reduced, as firms throughout the country hire new workers to meet the new demands released by tax reduction. The economic prospects of our depressed area will improve as investors obtain new incentives to create additional productive facilities in areas of labor surplus. . . .
>
> Price stability can be maintained. Inflationary forces need not be revived by strengthening the economy at a time of a substantial unemployment and unused capacity with a properly conducted program of tax reduction. With the gains in disposable income of wage earners there should be less pressure for wage increases in excess of productivity--and with increased profits after tax there should be no pressure to raise prices. . . . This nation is growing--its needs are growing--and tax revision now will steadily increase our capacity to meet those needs at a time when there is no major bottle-necks in manpower, plant, or resources, no emergencies straining reserves of productive power, and no lack of vigorous competition from other nations.[2]

The proposed rate reductions would not become fully effective until January 1, 1965. They would provide, in total, a reduction in tax liabilities of $13.6 billion; $11 billion for individuals, and $2.6

---

[1] U.S., Congress, House, Committee on Ways and Means, Hearings, The Tax Recommendations of the President Contained in his Message Transmitted to Congress January 24, 1963, 88th Cong., 1st Sess., 5-27.

[2] Ibid., p. 7.

billion for corporations. Other adjustments, some of which lose and some of which gain revenue, would on balance produce a revenue gain of $3.4 billion leaving a net reduction of $10.2 billion.

The $11 billion reduction in personal liabilities would take effect over a three-year period:

1. Calendar year 1963 - a rate schedule of 18.5 to 84.5 per cent and reducing the appropriate withholding rate upon enactment from 18 per cent to 15.5 per cent. The new tax rate would apply to the entire calendar year and, therefore, would require a lower withholding rate to prevent overwithholding;

2. Calendar year 1964 - a rate schedule of 15.5 to 71.5 per cent, effective for the entire year, and a withholding rate of 13.5 per cent as of July 1 of that year;

3. Calendar year 1965 and thereafter - a permanent rate schedule of 14 to 65 per cent, maintaining the withholding rate of 13.5 per cent.[1]

The reduction in the corporate income tax rate would cut corporate tax liabilities by $2.6 billion per year. This would be in addition to the reduction of $2 billion per year provided by the 1962 investment tax credit and depreciation reform. The corporate rate reduction would also take effect over a three-year period.

1. Calendar year 1963 - present normal tax of 30 per cent, applicable to the first $25,000 of taxable corporate income, would drop to 22 per cent while the rates applicable to income in excess of $25,000 would remain at 52 per cent. This, in effect, reverses the present normal tax of 30 per cent and the surtax of 22 per cent. The normal tax would remain permanently at 22 per cent;

---

[1] Ibid., pp. 13-14.

2. Calendar year 1964 - corporate surtax would be reduced to 28 per cent, thereby lowering the combined corporate rate to 50 per cent;

3. Calendar year 1965 and thereafter - corporate surtax would be reduced to 25 per cent, thereby lowering the combined corporate rate to 47 per cent.[1]

While the rhetoric of the Kennedy tax message is easy to enjoy, it still must be grounded in sound logic, analysis, and empirical experience. In order to review the theory of this particular tax cut, it is necessary to review the whole relationship of Keynesian economics to public finance.[2] This relationship is centered around Gross National Product, capital investment, and consumption, or that part of disposable income that is consumed. These relationships can be seen in the national income accounts that measure Gross National Product (GNP). Table 3-1 summarizes these relationships.

An increase in product of investment or consumption goods means an increase in GNP. What this means for DI (and thus for C) depends on what happens to DI as GNP changes. If a billion dollars added to GNP always meant a billion dollars added to DI, there would be no problem; this is not the case. To find out what happens to C (and therefore to GNP), it is first necessary to establish what changes can be expected in each of the items that intervene between GNP and DI when GNP changes.

Business transfer payments can be disposed of easily--they are first subtracted (3) and then added (9). Of the remaining items, seven (2, 4, 5, 8, 10, 11, 12) are government items; three (1, 6, 7) are

---

[1] Ibid., pp. 14-15.

[2] The following analysis is derived from Garder Ackley, Macroeconomic Theory (New York: The Macmillan Co., 1961), pp. 300-310.

TABLE 3-1

GNP DERIVATION

GNP (gross national product)
<u>minus</u> 1. capital consumption allowance (depreciation) <u>equals</u>

NNP (net national product)
<u>minus</u> 2. indirect business taxes
<u>minus</u> 3. business transfer payments
<u>minus</u> 4. current surplus of government enterprises <u>minus</u> subsidies <u>equals</u>

NI (national income)
<u>minus</u> 5. corporate profit taxes
<u>minus</u> 6. corporate undistributed profits
<u>minus</u> 7. corporate inventory valuation adjustment
<u>minus</u> 8. contributions to social insurance
<u>plus</u> 9. business transfer payments
<u>plus</u> 10. government transfer payments
<u>plus</u> 11. government interest <u>equals</u>

PI (personal income)
<u>minus</u> 12. personal taxes <u>equals</u>

DI (disposable income)
<u>minus</u> 13. personal savings <u>equals</u>

C (consumption expenditures)

business items. There are three classes of taxes, all of which are subtracted in going from GNP to DI. Some of these taxes can be considered as independent of GNP, such as property taxes and corporate franchise taxes. Most taxes, however, to one degree or another, produce higher revenues as GNP expands. Some, such as sales taxes, expand roughly in proportion to GNP; others, such as personal income taxes, expand more than in proportion. Corporate profits taxes play a peculiarly strategic role. These taxes are a rough constant proportion of profits before tax, but profits of corporations are very sensitive to changes in GNP. A rise or fall in GNP tends to be accompanied by a proportionately much

the already existing volume of depreciable assets. In fact, there is also some tendency for these allowances to be adjusted upward in good times and down in bad times as accountants attempt to protect the reported profit position of their firms from undue fluctuation. The effect is probably small, but it does act as a stabilizer. Corporate saving is one of the most important stabilizers. When corporate profits fall, businesses often fail to reduce dividends, or reduce them by much less. This means that corporate saving may easily go from a large positive figure in prosperous times to a negative figure in recessions; and vice versa. Because of the already mentioned sensitivity of profits to business conditions, this effect has considerable strategic importance as a stabilizer.

An example of the use of fiscal policy, albeit a somewhat accidental use to this end, is provided by the already discussed 1953-54 recession. Using the quarterly series (seasonally-adjusted at annual rates) of the U.S. Department of Commerce, the peak of GNP was reached in the second quarter of 1953, and the trough in the second quarter of 1954. Table 3-2 presents the relevant figures for these two quarters and shows the changes between them.

Over this period, investment and government expenditures declined by a total of $14.6 billion. There was an increase in the export surplus of $1.5 billion and an increase of consumption of $3.2 billion, producing a net decline in GNP of $9.9 billion. The important fact is that consumption increased in the face of a sizable decrease in GNP. The detail of the table provides the reason for this.

An unfavorable factor was the rise in capital consumption allowances (thereby reducing accounting profits). This primarily reflected

TABLE 3-2

GROSS NATIONAL PRODUCT AND RELATED ITEMS
SECOND QUARTERS OF 1953 AND 1954
(seasonally-adjusted annual rates in billions of dollars)

	Second Quarter 1953	Second Quarter 1954	Change
Gross national product	368.8	358.9	-9.9
Consumption expenditures	233.3	236.5	3.2
Gross private domestic investment	52.9	47.2	-5.7
Government purchases of goods and services	83.3	74.4	-8.9
Net exports	-.7	.8	1.5
Capital consumption allowances	26.2	28.5	2.3
Indirect business taxes	30.1	30.2	.1
Statistical discrepancy	2.0	-.8	-2.8
Subsidies less current surplus of government enterprises	-.4	-.3	.1
Corporate profits taxes	21.9	16.9	-5.0
Corporate undistributed profits	14.5	11.1	-3.4
Corporate inventory valuation adjustment	-1.6	0	1.6
Social insurance contribution	8.9	9.6	.7
Government transfer payments	12.7	14.9	2.2
Government interest	5.1	5.4	.3
Personal taxes	35.9	32.8	-3.1
Disposable income	252.8	254.8	2.0
Personal saving	19.6	18.3	-1.3
Consumption expenditures	233.3	236.5	3.2

Source: Gardner Ackley, Macroeconomic Theory, p. 304.

the extra depreciation on new capital equipment added over the year. Despite some drop in output and the reduction of some Federal excise taxes, indirect business tax collections also rose, reflecting rate increases by state and local governments. A third unfavorable factor was the increase in social insurance contributions of $.7 billion instead of the expected decline. This was the result of higher contribution rates which became effective during this period.

These unfavorable developments were more than offset. Corporate profits fell by $5.0 billion. This was the result of two factors: 1) corporate profits before taxes fell considerably, thereby causing a reduction of several billion in taxes; 2) the excess profits were abolished. Although after-tax profits still declined, corporations did not reduce their dividends; thus, corporate undistributed profits fell by $3.4 billion. Personal taxes fell by almost 10 per cent, partly as a result of the lower tax base associated with lower incomes, and partly through a reduction of Federal income tax rates. Transfer payments increased by $2.2 billion, partly as an automatic result of unemployment, and partly through an upward revision of the benefit structure. Thus, as a result of built-in flexibility plus reductions of Federal tax rates and liberalization of transfer payments, consumer disposable income increased by two billion dollars. A further unexpected bonus came from a reduction of personal saving so that consumption spending increased by $3.2 billion.[1]

This is a fairly simple example of how the built-in stabilizers of the fiscal system, plus a little tax cut, helped to prevent what might have been a severe reduction of output based on the amount of decline in investment and government spending. Instead of a decline in consumption spending being piled on top of the decline in investment and government spending, consumption actually held firm and led the way to subsequent recovery.

The foregoing relationships can be expressed in a simple mathematical model. The model, as it will be developed, is a Keynesian model

---

[1]Ackley, Macroeconomic Theory, p. 305.

and as such is the rationale for a tax cut to promote full employment. In its more sophisticated forms, it predicted the results of the Revenue Act of 1964.

If it can be assumed that all oonsumer earnings are not received as personal income and accept the view that consumption expenditures depend upon disposable income (a view that was not so easily accepted in Congressional hearings on the tax cut), the consumption function can be expressed as:

1. $$C = A + BY_d$$

where Y_d is disposable income. This inoome consists of several elements:

2. $$Y_d = Y - D - T + R$$

where Y is gross national product, D depreciation, T the aggregate volume of tax collections, and R the volume of transfer payments. To keep the model simple, it will be assumed that all corporate profits are distributed in dividends. Gross national product consists, then, of three parts:

3. $$Y = C + G + I$$

where G is the volume of government expenditures on goods and services and I is gross investment. A closed economy is assumed (no foreign transactions) and also unemployed resources are assumed from the beginning.

Substituting yields:

$$Y = A + BY - BD - BT + BR + G + I$$

4. $$Y = \frac{1}{1 - B} (A - BD - BT + BR + G + I)$$

This expression indioates that a ohange in government expenditures G is subject to the regular Keynesian multiplier of $1/(1-B)$ where B is the marginal propensity to consume disposable income on the

assumption that the other variables within the parentheses (D, T, R, and I) do not change as G and Y change. On the other hand, a change in T, all other variables constant, will produce a change in Y equal to the change in T times -B/(1-B). This tax multiplier is negative because a decrease in taxes will increase income and it is necessarily smaller than the government expenditures multiplier because B is necessarily less than 1. An increase in transfer payments is subject to the same multiplier with reversed sign, B/(1-B).

Thus, these elementary manipulations reveal that, for example, a one billion increase in government deficit caused by an increase in expenditures, taxes, and transfers held constant, will have a larger effect on income and output than the same change of deficit created by a tax reduction. The reason is that a deficit increase of one billion dollars, created by higher spending on current output, creates in the first instance an increase of one billion in output which is subject to the multiplier. If taxes are reduced by one billion, the initial increase in demand and output is for consumer goods. This increase will not be one billion, but B times one billion, for 1-B of the tax reduction will be added to savings by the initial beneficiaries. This in turn is subject to the usual multiplier, 1/(1-B), making the total increase B/(1-B).

One useful extension of this model is to determine how much taxes should be reduced to achieve a full employment gross national product. Assume the relevant functions to be as follows:

in billions of dollars

$$C = 10 + .8Y_d \qquad I = 5 + .11Y$$

$$Y_d = Y - D - T + R \qquad D = 10$$

$$Y = C + G + I \qquad R = 0$$

$$T = .2Y$$

Solving this model yields the expression:

$$Y = 28 + 4G$$

Thus, if G equals 30, Y is 148, T is 29.6, Y_d is 108.4, C is 96.72, I is 21.28. If it is known that at full employment, given the present availability of resources and capacity, gross national product would be equal to 200, what amount of reduction of taxes from the present level of 29.6 would be required to raise GNP to that 200 level? Substituting the known variables into equation 4 gives:

$$200 = \frac{1}{1-.8}(10 - 8 - .8T + 30 + 21.28)$$

Solving for T yields:

$$T = 16.6$$

At the 148 level of GNP, tax collections amounted to 29.6 At the 200 level of GNP, with all other expenditures held constant, tax collections would drop to 16.6, or a reduction of 13.0.

The use of models such as above can be extremely useful in the pursuit of an active fiscal policy. Yet, it must be remembered that their applicability is specifically limited by the assumptions employed in the models. These assumptions, and therefore some of the criticisms, are as follows:

1. As already noted, the fiscal assumptions are crude, such as a single tax function applicable to aggregate income, and a single average consumptions function which is also applicable to limited groups,

i.e., taxpayers. In defense, however, refinement requires more elaborate theories and, therefore, introduces new sources of error.

2. The model is static. The assumption, therefore, implied in its use, is that an equilibrium analysis can be relevant to policy matters. Specifically, the analysis compares an initial equilibrium situation with a new equilibrium which results from the introduction of given changes in taxes. Is the situation of the economy in which such changes may be introduced ever an equilibrium one? Does a new equilibrium result, and within a time frame that makes the analysis meaningful?

3. The analysis is limited to situations of less than full employment, which is to say that there are unused resources available for production.

4. Closely related to the above, the analysis is conducted either on the assumption of constant wages and prices or else that wages can change without affecting any of the relationships of the model. To assume that wages and prices can remain unchanged in the face of substantial changes in the level of demand, output, and employment is probably not realistic.

5. The rate of interest is assumed not to vary, or else that its variation makes no difference.

6. The assumption is made that real consumption expenditure is a stable function of real disposable income. This means that the price level, rate of interest, quantity of money or total assets, and the distribution of income are of little or no concern.

7. The assumption is made that real investment is either (a) autonomous or (b) a function of real total output. This assumes that private investment is either (a) unaffected by the volume of

government expenditure and by the levels of tax rates or (b) is affected only through the net effect of these on the level of income. The possibility that changes in tax rates may affect the willingness of entrepreneurs to assume investment risks is thus assumed away.

8. A closed economy is assumed. This is not appropriate for an economy in which international transactions are important.

9. It is implied in the previous assumptions that purely financial aspects of government fiscal operations make no difference. That is, if there is a government deficit, it matters not whether the deficit is financed by borrowing from the public, from the banking system, or by printing money. Monetary policy makes no difference. This is sometimes treated as more than an assumption. Some argue that finance can make no difference. If government deficits and/or investments increase, savings must increase in an identical amount. If the government deficit is financed by selling bonds, the public can buy these bonds with the enlarged savings. If the deficit is financed by the printing press, the new money becomes the asset form in which the enlarged saving is held.[1]

Before returning to the Revenue Act of 1964, two important theoretical concepts should be discussed--"fiscal drag" and "full-employment surplus."

Fiscal drag is the name for the automatic growth in tax revenues in an economy with a progressive tax structure and steady overall growth. As the economy grows more and more, revenue is siphoned off from personal income. As can be readily seen, fiscal drag is one side of the two-edged sword of built-in stabilizers of the economy. It can

---

[1]Ibid., p. 346.

be a blessing in one context, as it was during the 1953-54 recession, but on the growth side it can be a drag. According to Walter Heller:

> . . . The vaunted "built-in flexibility" of our tax system, its automatic stabilizing effect, is a mixed blessing. True, it cushions recessionism which is good. But left to its own device it also retards recovery by cutting into the growth of private income, which is bad at least until the production gap is closed and inflation threatens.[1]

In order to point out the importance of the fiscal drag and how it can retard growth, a second concept has been introduced--the full employment budget surplus. This was alluded to in the mathematical model that solved for tax collections at the full-employment level of GNP. Paul Samuelson defines the concept as a measure of:

> . . . what would be the budget position if the economy were at full employment [accepted by many as 4 per cent unemployment] and the legislated tax and spending structures were in effect. Unless tax rates are cut or expenditures increased, there would be in every healthily growing economy an increase in the full-employment surplus and a resulting fiscal drag.[2]

Figure 3-1 depicts the full-employment and actual budget in graphic relationship. Even though the actual budget graph indicates a deficit most of the time from 1958 to 1965, the full-employment budget line shows that there was a surplus in the full-employment budget. Growth of the economy would have enlarged the full-employment surplus every year and produced the fiscal drag, if there had not been the expenditure increase in 1961 and 1962 and the tax reduction of 1964.

---

[1]Heller, New Dimensions, p. 65.

[2]Paul A. Samuelson, Economics (New York: McGraw-Hill Book Co., 1967), p. 344.

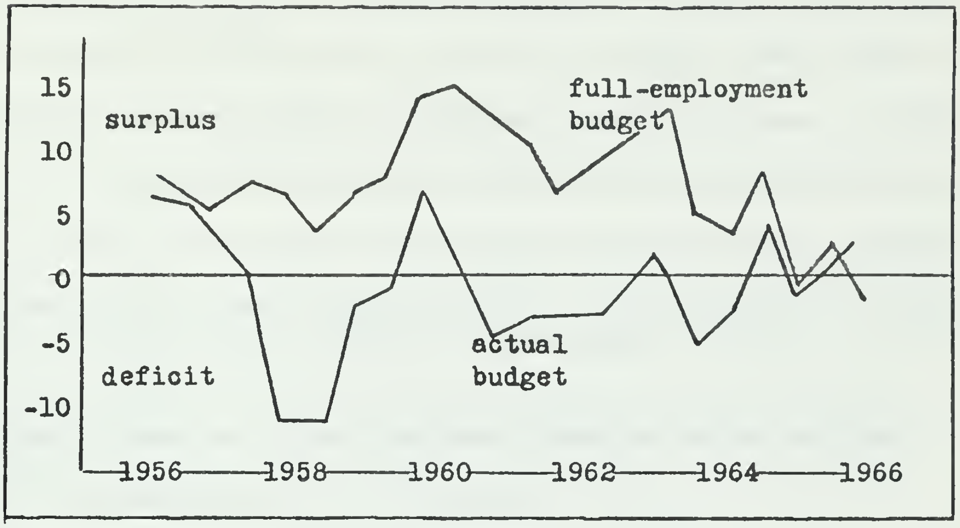

Fig. 3-1.--Full-employment and Actual Budgets

Source: Paul A. Samuelson, Economics, p. 345.

The CEA introduced the full-employment budget in their 1964 report.

> The economic impact of a given budget program is best measured by its surplus/deficit at full-employment income levels. The surplus in the full-employment budget is too large when the Government demand contained in the budget, and private investment and consumption demands forthcoming from after-tax incomes, are insufficient to bring total output to the full-employment level. . . .
>
> The appropriate size of the surplus or deficit in the full-employment budget depends on the strength of private demand and its responsiveness to fiscal policy. The budget must counterbalance private demand. The weaker the underlying determinants of private demand, the more expansionary the budget should be; the stronger these determinants, the more restraining the budget should be.
>
> Whether a given budget is too expansionary or restrictive depends also on other Government policies affecting private spending, of which monetary policy is the most important. Other things being equal, a strongly expansionary monetary policy permits a larger surplus by strengthening business investment, residential construction, and other expenditures that are sensitive to the cost and availability of credit.[1]

---

[1]U.S., President, Economic Report of the President, 1964 (Washington, D.C.: Government Printing Office, 1964), pp. 39-42.

The oonoept of full-employment budget and fisoal drag, while being an extremely useful devioe by which to analyze fiscal policy, was not acoepted without its share of Congressional criticisms. A brief sample of a dialogue between one-time CEA Chairman Gardner Aokley and one-time Senator and economist Paul Douglas affords ample evidenoe:

> Senator DOUGLAS: How would you define a full-employment defioit so that you would know whether you had found it or not?
>
> Chairman ACKLEY: For any particular period we oalculate what the fiscal program of the Government would do to the balanoe between expenditures and taxes if the economy were operating at some presoribed level of employment. . . .
>
> DOUGLAS: Well, now this has to be oonducted in a money economy.
>
> ACKLEY: Right.
>
> DOUGLAS: What do you assume on prioes?
>
> ACKLEY: The measurement of the full employment surplus or defioit, would be affeoted to some extent by changes in prioes. But price changes would involve roughly equivalent expansion of both the revenue side and the expenditure side in dollars, so that--
>
> DOUGLAS: Well, I am not speaking so much of Government finances as in the private structure outside of Government. Now you say there is full-employment deficit if the sum total of price tags on goods exceeds the sum total on goods which either are produced or could be produced with an unemployment rate of only 4 per cent as compared with the total monetary purchasing power in the pockets of consumers?
>
> ACKLEY: No, I think the concept of full-employment surplus as we have it in this paper . . . .[1]

And the fiscal drag:

> DOUGLAS: Now you go to fiscal drag. You say there is a fiscal drag when there is a full-employment surplus?
>
> ACKLEY: No, we have tried to define the term "fiscal drag" rather more narrowly. It is defined in terms of the drag on purchasing power in the economy that results from the normal

---

[1]U.S., Congress, Senate, Joint Economio Committee, Hearings, Fiscal Policy Issues of the Coming Decade, 89th Cong., 1st Sess., 18.

growth of Federal revenues that goes along with the growth in our potential output. If our potential output grows at about 4 per cent, or 3 3/4 per cent as it is currently doing, then our Federal revenues would rise something like $7 billion a year. Unless that drag is offset by either tax reduction or by an equivalent increase in Government expenditures, there is a drag on purchasing power, and therefore on the growth of incomes and production.

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

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

DOUGLAS: Well, my time is up, but when it becomes my time again I would like to have you go back to this point as to how purchasing power vanishes in thin air if the surplus is used to buy bonds and releases purchasing power of private individuals. Either you or I have been saved by the bell, I don't know which.[1]

If all the theories of new economics rested on sound logic and rigorous proof, they still lacked the most important criterion of success, and that was successful precedent. The American political arena has never been predisposed to learning its lessons, economic or otherwise, from the experience of other nations. It took nine months for the House of Representatives to pass the measure with a vote of 271 to 155. Forty-eight Republicans deserted their party leadership to vote for tax reduction.

The Senate received the bill from committee hearings in January, 1964, and after a minimum of debate passed the bill, 77 to 21. It is interesting to note that this roll call almost exactly inverted the last

[1]*Ibid.*, p. 21.

previous Senate vote on tax reduction as an instrument of fiscal policy in June 1958.

The Revenue Act of 1964 as passed by Congress is slightly different from that which was originally proposed. Due to the delay in passing, the reduction in income tax rates were to take place in two stages--one in 1964 and the other in 1965--rather than over a three-year period. Altogether, marginal tax rates for individuals were reduced to a 14 to 70 per cent range vice 14 to 65 per cent, and corporate income tax liabilities were reduced for most corporations to 48 per cent vice 47 per cent. When originally enacted, the tax cut in tax liabilities amounted to $13 billion at an annual rate, with $10.6 billion accruing to individuals.

Reduction in withholding for individuals--from 18 to 14 per cent --became effective in March, 1964, insuring that the tax reduction would have an immediate impact on after-tax incomes and hence would have a rapid, and eventually multiple, feedback on spending and output. Because the withholding rate was cut at the outset to reflect both stages of reduction, taxes withheld in 1964 left a larger than usual share of total liabilities to be paid in 1965.

The anticipated effect of the 1964-65 tax cut on aggregate spending was not long in materializing. By the first half of 1965 the gap between actual and potential GNP had narrowed by more than one-half from the $25 billion to $30 billion shortfall that had prevailed earlier.[1]

---

[1]U.S., Congress, Senate and House of Representatives, Subcommittee on Fiscal Policy of the Joint Economic Committee, Hearings, Fiscal Policy of the Coming Decade, 89th Cong., 1st Sess., 8.

Gardner Ackley, Chairman of the CEA from 1964-67, speaking before the Subcommittee on Fiscal Policy of the Joint Economic Committee, reflected that:

> Our strong economic advance through 1964 and the first half of 1965 reflects the dramatic relaxation of the tax burden on the economy through the Revenue Act of 1964, with an unprecedented drop in the full employment surplus shown on Figure 3-2 for early 1964.
>
> Previously in the decade, our periods of declining full-employment surpluses were confined to the tail end of recession and the early quarters of recovery. In both the 1957-58 and the 1960-61 recessions, the expansionary shift in fiscal policy occurred only in the final quarter of the recession. Once the shift was made, fiscal policy contributed actively to the support of recovery with a drop in the full-employment surplus of over $5 billion during the year 1958 and again during 1961. . . .
>
> Fiscal policy has helped to maintain overall balance in the economy in the period since 1960 through the changes in the full-employment surplus shown in Figure 3-2. The detailed budgetary changes that produced this result are set forth in Table 3-3. In the first quarter of 1960, our full employment surplus was $14 billion. If tax rates had been unchanged, full-employment revenues would have grown by nearly $30 billion from then to the second quarter of 1965. Had expenditures also remained constant at the level of the final quarter of 1960, the budget would have tightened steadily, with the full-employment surplus approaching $44 billion by mid-1965. The consequences for the economy would have been nothing short of disastrous.
>
> Instead, the Congress and the Administration took expansionary action totaling nearly $40 billion. We put to excellent social use the dividend of the $30 billion growth of full-employment revenues, as well as nearly $10 billion of the full-employment surplus.
>
> Over the period, expenditures grew $27 billion, declining somewhat as a fraction of GNP. About half of the increase went into purchases--mainly for defense. Another notable change was the rise in Federal grants-in-aid to States and localities, from $6 billion to $11 billion. Tax cuts accounted for about one-third of the total expansionary action.[1]

---

[1]Ibid., 7-8.

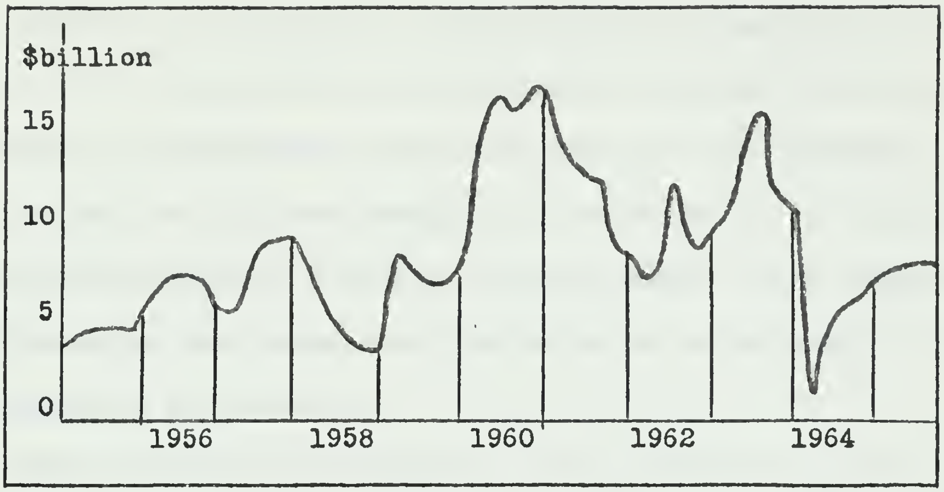

Fig. 3-2.--Federal Full-Employment Surplus

Source: Joint Economic Committee.

TABLE 3-3

FEDERAL FISCAL ACTIONS, 1960 IV TO 1965 II

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

Of course, the overall stimulus to economic expansion provided by tax incentives in this period was not confined to the tax cut in income tax. It also included the very significant lagged effects of the investment tax credit and liberalized depreciation allowances enacted in 1962, as well as an additional liberalization of the investment tax credit enacted in 1964 (the Long Amendment), which eliminated the 1962 provision that actual tax credits had to be deducted from the base in computing depreciation.

There was still some concern in early 1965 about the tendency for actual GNP to fall short of its potential.[1] To help offset this continuing drag and at the same time make good on a long-deferred promise to reduce indirect taxes levied in World War II, a multiple staged cut in Federal excise taxes was enacted in 1965, the Excise Tax Reduction Act. This provided for a lowering or elimination of excise taxes on consumer durable goods, telephone service, and certain other items. The first stage--amounting to a $1.7 billion cut at an annual rate --became effective in mid-June 1965; the second stage--of an equal amount--was scheduled to become effective in January 1966; however, this second stage was virtually eliminated by the Tax Adjustment Act of 1966.

By mid-1965, just prior to the escalation of fighting in Viet Nam, the economy had made fairly good progress toward full-employment. GNP had grown some 13 per cent in the three years from the end of 1962. While the unemployment rate of 4.5 per cent in 1965 was still above the target level of 4 per cent, it was a full percentage point below the 1962 level. Wholesale and retail prices of commodities had remained

---

[1]Ibid., 9.

quite steady through 1963 and advanced only slightly by 1965.[1]

Although the Revenue Act of 1964 is almost universally accepted as a successful venture into fiscal expansionary policy, it can be criticized on a legitimate ground; it did not structurally improve the economy sufficiently to alleviate the poverty of much of the country. The principal proponent of this view is Leon H. Keyserling, member of the CEA from 1946 to 1950 and chairman from 1950 to 1953. Speaking at the Economic Symposium that celebrated the twentieth anniversary of the Employment Act of 1946, he stated that:

> . . . Recent fiscal policies have shown egregious disregard for an appropriate blend of aggregate and structural approaches. The 1966 Report of the Council of Economic Advisors admits at long last the point I have been making for many years, that the three recessions since 1953 occurred because during the preceding upturn periods, investment in the plant and equipment which adds to our production capabilities was advancing much too rapidly relative to the expansion of demand for ultimate products in the form of consumer expenditures and public outlays at all levels of government. And the Council is now concerned that, during 1964 and 1965, this type of investment advanced more than twice as rapidly as GNP.
>
> Despite all this, the legislative and administrative tax reduction of 1962-65, having an annual value of close to $20 billion, directed almost half of this amount to corporate tax cuts and aspects of personal tax reduction designed to increase the rate of saving for investment purposes. This also served to limit or restrict policies pointed toward adequate expansion of private consumption and much-needed public services. . . .
>
> In consequence, at least a third of the tax cut was wasted. Some went overseas to increase our balance-of-payment problem; some of it was used for the noneconomic function of bidding up the stock market excessively; some of it was purely saved, or used to increase consumption among those least entitled to enjoy these increases, while almost a fifth of our people lived in poverty.
>
> To be sure, these incontinent tax cuts have stimulated the economy some; $20 billion a year thrown into the streets would

---

[1]U.S., President, Economic Report of the President, 1968 (Washington, D.C.: Government Printing Office, 1968), pp. 261, 264.

> have done that. But a very different structuring of the tax cuts, and a very different admixture of reduced taxes and increased public spending, would have provided much more efficient and immediate stimulus to the economy and been much more conducive to economic equilibrium in the long run. . . .
>
> So the tax cut has not worked wonders. More important still, the primary purpose of a fiscal policy through the Federal budget is not to enable us to increase or decrease taxes, depending upon whether or not we want to speed up or slow down the economy. The primary purpose is to induce the goods and services which the nation needs most and cannot otherwise get. This is what the Federal budget is all about. Largely in consequence of the tax cuts, the fiscal 1969 budget continues a downward trend in domestic public outlays measured against the size of our national product. Some of the social programs which sound more and more splendid remain only token programs.[1]

While Keyserling's argument concerning the correct mixture of aggregate and structural expansionary fiscal policy is sound, he has failed to realize the disproportionate effects of increased spending on Viet Nam that occurred in late 1965. Prior to that time the expansionary action had taken a two-thirds, one-third division between expenditure increases and tax reduction (see Table 3-3). The upsurge in total Federal outlays that developed following the escalation of fighting in Viet Nam, coming as it did at a time when the economy was already moving toward high employment, tipped the balance of economic pressures toward inflation. By the spending priorities that developed relevant social programs of the Great Society were necessarily allotted reduced funds.

After 1965 the success of the Revenue Act of 1964 became clouded with the pressures of inflation. Yet in the relatively short time period from 1964 to mid-1965, the economy was well on its way toward full employment with the necessary stability in the price structure. Yet the fuller use of the nation's resources posed new questions of

---

[1]U.S., Congress, Senate and House of Representatives, Joint Economic Committee, Hearings, Twentieth Anniversary of the Employment Act of 1946, an Economic Symposium, 89th Cong., 2nd Sess., 21-22.

diagnosis and application. In the early 1960's the economic and political risk of fiscal expansion had been minimal because aggregate demand was insufficient. As the unemployment rate fell toward 4.0 per cent, the economy entered territory that it had not occupied for nearly a decade. The risk of excessive demand was real. Stabilization policy --that of reconciling high employment with reasonable price stability --was in President Johnson's words, "a welcome task."[1] Yet by late 1965 this welcome task was immensely complicated by commitments in Viet Nam. The smell of war was in the air. The political and economic pendulum was swinging again from unemployment to inflation.

---

[1]U.S., President, Economic Report of the President, 1966 (Washington, D.C.: Government Printing Office, 1966), p. 21.

CHAPTER IV

THE REVENUE AND EXPENDITURE CONTROL ACT OF 1968

> Following the major tax cuts of 1964 and 1965--equivalent to about $23 billion in today's economy--the booming economy of 1965 and 1966 brought Federal revenues into balance with Federal spending. In both years, there was a small Federal surplus on the comprehensive national income accounts basis.
>
> The slowdown in economic growth that began in late 1966 dampened the growth of revenues. At the same time, the cost of our commitment to freedom in Southeast Asia was steadily rising.
>
> As a result, the Federal sector plunged into deficit --$12.5 billion in calendar year 1967.[1]

Thus, President Johnson reported that the economy, as close as it was to full employment in 1967 (3.7 per cent unemployed), was creating problems of fiscal management. The "commitment to freedom in Southeast Asia" was, indeed, a principal cause. From the middle of 1965 to the end of 1967, the increase in Federal expenditures, as shown in Table 4-1, was $48 billion. Of this amount some $25 billion was for defense. Of the $10 billion increase in OASDHI benefits, about $6 billion represented the decision to provide improved health care for the aged under social security (medicare), and the balance represented normal growth in the ongoing programs. Over the same period, normal growth of Federal revenues at full employment--at constant tax rates--amounted to about $27 billion. Inasmuch as there were tax rate increases, about $6 billion was added

---

[1]U.S., President, Economic Report of the President, 1968, p. 9.

to revenues.[1]

TABLE 4-1

FEDERAL FISCAL ACTIONS IN TWO PERIODS SINCE FOURTH QUARTER 1960
(Billions of dollars, seasonally adjusted annual rates)

Item	1960 IV to 1965 II	1965 II to 1967 IV
Federal expenditure increases	25.5	48.0
Defense purchases	3.5	25.0
Other purchases	7.5	1.5
OASDHI benefits	5.0	10.0
All other	9.5	11.5
Federal tax reductions	12.5	-6.0
Corporate	5.5	-
Personal	8.5	-
OASDHI payroll taxes	-3.0	-8.5
Indirect business	1.5	2.5
Total expansionary actions	38.0	42.0
Normal revenue growth at full employment .	30.5	27.0
Change in full employment surplus	-7.5	-15.0

Source: Economic Report of the President, 1968

All in all, because of the large rise in defense outlays and the high priorities for certain public (social) programs, the $48 billion increase in expenditures far outpaced the normal expansion of revenues and tax rate increases. As a result, the Federal budget became very expansionary over the period 1965-1967; the result was a drop of almost $15 billion in the full-employment surplus.[2]

---

[1]Ibid., p. 69.

[2]Ibid.

A variety of policy procedures--both fiscal and monetary--was developed from mid-1965 through 1967 to cope with the increased spending in the defense budget and the pressures that it brought on the economy. This task was made difficult by the uncertainties of the Viet Nam conflict; the amount of expected increases in defense was subject to many variables--the quest for peace being the prime one.[1]

A previously scheduled rise in payroll taxes for social security of $6 billion took effect at the beginning of 1966. The President's budgetary program reinforced this restraining action by requesting a new graduated withholding system on individual income taxes. Also, the Administration requested that certain excise taxes be reimposed as well as speeding up the collection of corporate income taxes. These measures were enacted by the Congress in March, 1966, and thereafter took in $2.5 billion annually from the economy.

Nevertheless, a large part of the burden of providing restraint fell on monetary policy.[2] The FED followed a tight monetary policy which resulted in the "crunch of 1966." The FED raised the discount rate in late 1965; thus, the volume of non-borrowed reserves and the rate of growth of the money supply were reduced considerably. The FED, in retrospect, realized that it had reacted too strongly.[3]

> As 1966 progressed, it became clear that Federal spending and borrowing would be much larger than initially projected and that strong inflationary pressures would persist. To help counter these pressures, monetary policy was tightened substantially. With demands for funds from private sectors very large --reflecting to some extent the unexpected acceleration of

---

[1] Ibid.

[2] Ibid., p. 70.

[3] "Monetary Policy in the 1960's," Federal Reserve Bulletin, September, 1968, p. 714.

> corporate income tax payments--interest rates rose steeply. Credit rationing by lending institutions became severe, particularly in markets for the financing of housing,[1] and by the late summer of 1966, these pressures were creating signs of disorder in financial markets that threatened to brake the pace of economic activity much too sharply.

Business investment spending, however, proved unresponsive to the 1966 tight monetary policy. It continued to advance at a rapid rate during the first and second quarters of 1966. The Council of Economic Advisors considered that fiscal policy must take more of a role in restraining the economy:[2]

> The investment boom put severe strain on the plant capacity and labor supplies of the machinery and construction industries. There was also danger that an excessive and unsustainable surge in plant and equipment spending might set the stage for a subsequent slump in investment demand. Finally, the investment boom added mightily to the pressures on financial markets during the spring and summer of 1966.
>
> The dramatic decline in home building, the highly disturbed atmosphere of financial markets, and the pressures of business fixed investment on capital goods industries clearly indicated that fiscal policy needed to assume a larger share of the responsibility for restraining the economy.

For these reasons, the Administration in September of 1966 requested a temporary suspension of the investment tax credit and initiated various cutbacks in Federal spending. At the same time, monetary policy was relaxed. The suspension of the investment tax credit was enacted by the Congress in October, 1966. In the first half of 1967, the investment boom declined somewhat as a result of the investment credit suspension and the general slowdown of the economy.[3]

---

[1]The annual rate of new housing starts declined from an average of about 1.5 billion in 1965 to 900 million units in 1966.

[2]U.S., President, Economic Report of the President, 1968, p. 70.

[3]Ibid.

Throughout the first half of 1967, Federal fiscal policy again exerted an expansionary influence on the sluggish economy. Federal defense purchases rose $6.9 billion (at an annual rate) between the fourth quarter of 1966 and the second quarter of 1967. Also, Federal transfer payments to the private sector rose $3.5 billion. While outlays increased, receipts remained about the same due to the decline in economic activity. The Federal deficit, which had been $3 billion (at an annual rate) in the fourth quarter of 1966, rose to nearly $15 billion in the second quarter of 1967.[1]

The force of inflation since 1965 can be shown with considerable clarity by the behavior of the Consumer Price Index (CPI). It rose 2.5 percentage points between June, 1965, and June, 1966; during the next eighteen months the climb was 2.7 percentage points.[2] While these advances were broadly based, they were particularly large for the service industries. In fact, it is in the service industries that inflation can most clearly be traced.

Charges for consumer services increased markedly after 1964. From 1967 to 1968, prices of services increased 5.1 per cent compared with 4.4 per cent in the preceding year and 3.7 per cent in 1965-66.[3]

---

[1] Ibid.

[2] Ibid., p. 280.

[3] About half of the services represent the output of service industries where labor costs are a high proportion of total costs and where typically productivity gains are limited. Large wage advances in 1967, stimulated by manpower shortages and augmented by the further boost in February, 1968, of Federal minimum wages (they had been extended to cover service industries), have contributed significantly to the acceleration in service prices.

Among the "labor intensive" servioes, medical oare--an area of long standing manpower shortages and rapidly expanding demand--was the most rapidly rising sector in 1967 and 1968. Costs of these servioes increased 7.1 per oent from 1967 to 1968. This increase was less than the 9 per cent increase in 1966 to 1967 when the introduction of the medicare program caused costs that year to increase rapidly, but the 1967 increase was more than double the 1965 inorease.[1]

Mortgage interest rates, which advanced sharply in 1966 under the impact of tight monetary policy, had little net change during 1967; however, they rose considerably in 1968. During 1968, they rose 6 per cent as compared with a rise of 3.5 per cent from 1966 to 1968.[2]

In general, by almost any standard, prices were relatively stable prior to the aoceleration of military activity in Viet Nam in 1965.[3] Unit labor costs in the second quarter of 1965 were 98.8 per cent of the 1957-59 base.[4] The Viet Nam buildup, however, put strong demand on heavy industry, and in 1966 prices advanced sharply in defense industries and the oapital goods sector; the inoreased expenditures pressed unevenly on capacity and skilled labor. By the end of 1966, unit labor costs had risen to 102.4--a gain of 3.6 percentage points.

As the economy pioked up speed near the end of 1967, prices and wages again accelerated. The union wage settlements in late 1967 and

---

[1]U.S., President, Economic Report of the President, 1968, p. 279.

[2]N.I.C.B., Economic Almanac, 1968, p. 102.

[3]Although the failure of industries with decreasing costs to reduce prioes during the period is partly responsible for the failure of price increases in the services to be fully offset by decreases elsewhere, the period 1961 through mid-1965 was still one of relative prioe stability.

[4]N.I.C.B., Economic Almanac, 1968, p. 53.

early 1968 caused an even further aggravation in price and wage increases.

The Administration's first request for a surtax on personal and corporate income occurred in early 1967. While the pace of the economic expansion was continuing to slow, the Administration proposed that the Congress enact a temporary 6 per cent surcharge on personal and corporate income to become effective in July, 1967, and run for two years or until commitments in Viet Nam tapered off. This request reflected an assumption that the rate of economic expansion would accelerate sharply again after mid-1967 and, thus, would require more fiscal restraint if inflationary developments were to be checked without risking an overly abrupt return to credit restraint. With economic activity slowing in the first half of 1967, the Congress showed little willingness to accept the Administration's proposal, nor did the Administration press its case very strongly. In fact, the Administration felt the need to call for a quick restoration of the investment tax credit.

By the summer of 1967, however, the economy was showing signs of overheating. As has already been mentioned, Federal budget receipts were not increasing correspondingly due to the general slowdown of economic activity. With deficit financing expected to reach a new peacetime high, private borrowers scrambled aggressively to cover, through anticipatory financing, the bulk of their expected needs. Consequently, even though monetary policy remained relatively easy, interest rates rose sharply to levels above the previous World War II peaks that were also reached in the 1966 period of credit restraint.[1]

---

[1]"Monetary Policy in the 1960's," Federal Reserve Bulletin, September, 1968, p. 715.

Since much of this renewed pressure on credit markets reflected expectations of developments likely to result from an overly stimulative fiscal policy, the Administration, in early August, reiterated its request for the enactment of a surtax. Because it seemed likely that any final action on the proposal would come well after the July, 1967 effective date originally proposed, the requested surtax was raised from 6 to 10 per cent.

Accordingly, the Administration's economic "Troika"--Secretary of the Treasury Fowler, Director of the Budget Schultze, and CEA Chairman Ackley--went to Capitol Hill to present their case:[1]

> We have concluded that this proposal, supplemented by a speedup of corporate tax collections and a temporary deferral of scheduled excise tax deductions, is not only consistent with the objectives of sustained growth, high employment, and price stability, but necessary if these objectives are to be successfully pursued.

The rationale for the surtax was presented by Secretary Fowler in the following manner:[2]

1. To hold down the deficit - The Bureau of the Budget, in revising its expenditure and receipt estimate for fiscal 1968, concluded that the Federal deficit, without the tax surcharge and tight expenditure control, could range as high as $29 billion--with both tax surcharge and expenditure control the deficit was estimated to fall within a range of $14 to $18 billion (actual deficit, fiscal year 1968--$25 billion, unified budget).

2. To meet the special costs associated with Viet Nam - In the latter part of 1966, it was apparent that the "special" or extra costs

---

[1]U.S., Congress, House, Committee on Ways and Means, Hearings, Tax Proposals of the President, 1967, 90th Cong., 1st Sess., 1967, p. 14.

[2]*Ibid.*, pp. 16-25.

of the Viet Nam war in fiscal 1967 would be nearly double those originally estimated in the January budget. These costs were estimated to be in excess of $22 billion.

3. To avoid excessively high interest rates and tight money - The failure to hold down the budget deficit would create an inflationary environment in which private credit demand would soar, and in which it would be more difficult to continue an expansionary monetary policy; this would correspondingly cut down on total available supplies of credit. Private demands, in the absence of a tax surcharge, would be expanded in three ways--by the enlargement of Federal credit demands, by a swelling of private demands themselves, and by the curtailment of total credit supplies. The net result would be a different set of credit market conditions, imposing a heavier net demand for funds that could not be met by institutional lenders, and that could only be met in part by the residual sector made up mainly of individuals.

4. To protect healthy economic growth and price stability - Whenever the economy is operating at close to full use of its productive resources, a net increase in government expenditures cannot fail to be paid for by a slower growth of real income in the private economy. Extra production necessary to meet the needs of the government must necessarily be matched by lower production to meet private needs.

5. To protect the balance of payments - The tax increase would encourage sound, balanced, economic growth and that would be most favorable to the balance of payments position. Over the period of 1961-64, when GNP rose on the average by about 6 per cent annually, the U.S. trade surplus increased almost $2 billion, from $4.8 billion in 1960 to $6.7 billion in 1964. Without the tax increase, a faster, less

balanced growth in the economy will occur. This can lead to a substantial increase in imports. In 1965 and 1966, when GNP rose at an annual rate of 8 and 9 per cent, imports rose by 15 and 18 per cent, respectively. This was far more than the corresponding increase in exports. As a result, the trade surplus deteriorated steadily from $6.7 billion in 1964 to $4.8 billion in 1965, $3.5 billion in 1966, and $3.6 billion in 1967.

To produce the needed revenue the President's proposal for the surtax contained three points:[1]

1. A temporary surcharge of 10 per cent of tax liability (not 10 per cent of taxable income) to be placed on corporations and those individuals with tax liability above an exemption level (1,000; 1,500; or 2,000 taxable income, depending on marital and/or household status);

2. A speedup in corporate income tax collections;

3. A postponement of the scheduled excise tax reductions on automobiles and telephone service during the period of the temporary surcharge.

The Administration's case for a tax increase was well supported by private industry and by business and academic economists. The Investment Bankers Association, Aluminum Company of America, United Steel Workers, the Association of American Railroads, and many other companies and associations joined in support of the tax increase. Also, a rather impressive petition signed by 455 prominent businessmen who supported the surcharge was sent to the Ways and Means Committee. A similar letter signed by 320 academic economists stated the following:[2]

---

[1]Ibid., p. 25.

[2]Ibid., p. 631.

> . . . We are in agreement that--given the projected size of military outlays--cuts in Federal civilian programs by enough to avert the need for a tax increase are highly unlikely. Many of us feel that, even if they were possible, such cuts would be poor--indeed, dangerous--social policy in the light of the conditions of millions of our citizens living in the ghettoes of our cities.
>
> We favor a flexible tax policy, which means raising as well as lowering taxes when needed. . . . We urge early enactment of tax legislation along the general guidelines proposed by the President.

Regardless of the widespread support for the surcharge--more unanimous at this stage than was the request for a tax cut in 1963--the proposal was greeted with considerable Congressional opposition. This opposition persisted in the face of a massive budgetary deficit that loomed ahead for fiscal year 1968. The "on-again-off-again" experience with the tax credit suspension had tended to create resistance to fine-tuning the economy through fiscal action.

An article that appeared in the Los Angeles Times by Professor Harold M. Somers expressed the doubts that many had:[1]

> . . . Some of the opponents of the [tax] plan think that domestic spending should be cut. Others believe the Viet Nam war should be de-escalated or ended by withdrawal. Many just don't like taxes.
>
> And a few are afraid that a tax increase of this size will bring on a depression. They can point to some important indications that we are not exactly in a state of booming prosperity:
>
> Corporate profits are below last year's figure.
> Unemployment is at 3.9 per cent of the labor force, and is still evidently high enough to provoke riots. . . .
> Excess productive capacity is greater than a year ago in many industries.
> The stock market seems to be in doubt as to what to do.
>
> Despite all this, most economic forecasts for the coming year are favorable. But what if the forecasts are wrong? Should we take a chance on bringing on a recession through a tax increase?

---

[1] Harold M. Somers, "Special Comment--The Great Tax Battle--A National Inflation 'Trust' Fund," Los Angeles Times, August 17, 1967.

Somers proposed that instead of a tax increase the government should enact a forced purchase of government bonds. This would ensure that the extra revenue would be immediately repayable when the economy strengthened.[1]

Congressional opposition within the Ways and Means Committee centered around the leadership of Chairman Mills. The Committee felt that executive control of expenditures and greater efficiency in operation was a necessary quid pro quo for any eventual tax increase. Mills was quoted by the Wall Street Journal as saying:[2]

> All of us know only too well that the present budget contains programs that may have lost their justification, and that we are called upon to approve others and vote sums for their operation, without having any information about what their current objectives are and how well they are performing them or likely to in the future.

As a result of this type of opposition, the Committee voted in early October to table the President's proposal until such time as an understanding could be reached between the President and Congress, i.e., Mills' Committee, on a means of employing more effective expenditure reduction and controls as an essential corollary to further consideration of the tax increase. By late November, the Administration was ready to discuss expenditure control.

The plan called for a reduction in total obligational authority for the fiscal year 1968 for each civilian department or agency in the following combined sum:

A two per cent reduction in the January budget estimated for personal compensation and benefits, plus a 10 per cent reduction in

---

[1] Ibid.

[2] "Wilbur Mills Makes a Point," Wall Street Journal, October 10, 1967.

such estimates for controllable programs other than personal compensation and benefits.

For the Defense Department, the reduction was to be 10 per cent of the new obligational authority requested in the January budget, excluding the special costs of Viet Nam.

These combined reductions in obligational authority would produce an expenditure reduction for fiscal year 1968 of $4 billion.[1]

Two more reasons for the surcharge were also presented at the November Hearings. The devaluation of the British pound just a week prior to the Hearings required prompt measures to protect the dollar from the vagaries of the international monetary system. The second reason was due to the fact that Congress had not cut appropriation requests by an amount anticipated by the Administration. In August, the fiscal 1968 deficit was estimated at $29 billion and only three of the fourteen appropriation bills for that year had been enacted. New obligational authority was expected to be reduced by Congress in the amount of $6 billion (covering several years). By late November, with all but two appropriations enacted, total obligational authority was cut by only $4.5 billion. This amounted to only $1.5 billion reduction for fiscal 1968.[2]

The passage of time necessitated revision of the original tax proposal. The updated recommendation called for the 10 per cent surcharge on corporate income taxes to be effective from January 1, 1968, through June, 1969; for personal income taxes (the same low income

---

[1]U.S., Congress, House, Committee on Ways and Means, Hearings, Continuation to Receive Further Administration Proposals Concerning Expenditure Cuts, 90th Cong., 1st Sess., 1967, p. 9.

[2]*Ibid.*, p. 12.

exemptions applied) the surcharge was to be effective from April 1, 1968, through June, 1969. For calendar year 1968, individuals would pay only 7.5 per cent of their annual tax liability due to the April effective date.[1]

The deadlock between the Administration and Congress concerning the expenditure cuts was resolved when it became evident that the economy was experiencing renewed inflationary pressures. Under public demand for some positive action to reverse the unfavorable developments of the preceding six months, a compromise was reached that involved both a surtax and a cut in spending. In fact, the total fiscal restraint package that was legislated in June, 1968, was more restrictive than many had expected.[2]

As finally passed, the Revenue and Expenditure Control Act of 1968 imposed the temporary 10 per cent surcharge on personal and corporate income taxes and, at the same time, set a ceiling on Federal outlays for fiscal year 1969. This ceiling was $6 billion below the $186.1 billion level of outlays that had been projected for this period in the January, 1968 budget. Certain categories, including Viet Nam related spending, interest on the debt, veterans affairs, and social security payments were exempted from the ceiling so that the total of actual outlays was estimated in January, 1969, to be in excess of $183 billion on an annual basis. Apart from these specific exemptions, however, the law reinforced the ceiling on total outlays by providing for cuts of $10 billion in requested appropriations, requiring gradual reduction in

---

[1] U.S., President, Economic Report of the President, 1968, p. 85.

[2] "Monetary Policy in the 1960's," Federal Reserve Bulletin, September, 1968, p. 716.

the number of Federal civilian employees, and calling for a recession of $8 billion in such unobligated balances as remain after June 30, 1969.

In addition, excise tax rates on automobiles and telephone service were kept unchanged, with the cut previously scheduled for April, 1968, postponed until January, 1970.

The Act further accelerated corporate income tax payments by increasing the 70 per cent estimating requirements to 80 per cent. Also, in this category, the Act provides for the gradual elimination over a ten-year period of the $100,000 exemption on estimated tax liability for pre-payment purposes.

The economic theory behind the tax cut seemed straightforward enough to the Administration economists:[1]

> . . . The economic effects of a tax increase are the mirror-image of the expansionary effects accomplished by tax reduction. A tax cut enacted when there are ample idle resources, as in 1964, has its main expansionary effect on output, with only a minor impact on prices. Under present circumstances, with rapidly expanding demands and essentially full employment, the main restraining impact of the tax increase will be on prices, and only secondarily on output. . . .
>
> The tax increase works to curb price increases by moderating the pressures of demand. However, like any other fiscal or monetary measure, it cannot cope immediately with cost pressures already built into the system. To be sure, some have argued that a rise in the corporate profits tax may in fact add to cost pressures, by inducing firms to raise prices in order to protect their profits from the impact of the higher tax. But any firm which was already taking full advantage of its opportunities to earn profits would have no incentive to raise its prices as a result of a higher corporate tax rate. The price which results in the largest profits before taxes yields the largest profits after taxes, regardless of the tax rate.

The CEA also assumed that wage-earners would not be able to demand greater wages to compensate for a lower take-home pay; companies

---

[1]U.S., President, Economic Report of the President, 1968, p. 87.

faced with a mellowing market and a large tax bill would not be disposed to such requests.

The CEA envisioned one more important facet of the surtax--its impact on long-term stabilization policy. The relative ease in which the act was passed, compared to the Revenue Act of 1964, demonstrated the political feasibility of making fiscal policy work on the unpleasant side--restraint--when taxes have to be raised rather than lowered. If the surcharge performed up to its expectations, it would be a culminating victory for the fiscal activists. It would complete the cycle, from expansion to stabilization. If successful, there would be little argument, political or economic, that the "new economics" was what they thought it to be--the only modern way to manage an economy.[1]

By January, 1969, the restraining effects of the surtax were a source of mild disappointment to the Johnson Administration. To the critics of the Administration, it was proof that fiscal stabilization policy was not the panacea for a booming economy.

The CEA felt that the poor showing of the surtax in 1968 was due to the late date of its enactment, and because of the fact that much of the burgeoning growth of the economy was already built into the system and could not easily be removed.[2]

> As a result of the enactment of this fiscal program, the Federal budget (as measured in the national income accounts) has shifted from a deficit of $11 billion in fiscal 1968 to one of only $1 billion (at an annual rate) in the second half of calendar year 1968. The tax surcharge alone is currently withdrawing about $10.5 billion (at an annual rate) from the income stream.

---

[1] Ibid.

[2] U.S., President, Economic Report of the President, 1969, (Washington, D.C.: Government Printing Office, 1969), p. 39.

The enactment of the surcharge and expenditure cutbacks immediately strengthened international confidence in the dollar and caused some relaxation in domestic financial markets. Economic activity continued to expand too strongly in the second half of 1968, but at a less feverish pace than in the first half.

In the last half of 1968, the growth of real GNP was 4.5 per cent. In current prices, this was a rise of $35 billion (Table 4-2).

TABLE 4-2

CHANGES IN VARIOUS MEASURES FROM THE NATIONAL INCOME AND PRODUCT ACCOUNTS SINCE SECOND QUARTER 1967
(Billions of dollars, seasonally adjusted annual rates)

Item	1967 II to 1967 IV	1967 IV to 1968 II	1968 II to 1968 IV
Gross national product	30.8	41.9	34.9
Change in business inventories	6.0	2.5	-.8
Final sales	24.7	39.4	35.7
Personal consumption expenditures . .	11.9	25.7	18.4
Business fixed investment	2.3	2.0	7.2
Residential structures	5.8	1.0	2.3
Net exports of goods and services . .	-1.7	-1.4	1.0
Government purchases of goods and services:			
Federal	3.5	6.5	1.6
State and local	2.8	5.6	5.2
Consumer sector:			
Personal income	23.6	32.9	30.1
Disposable personal income	18.1	26.7	16.2
Personal outlays	11.6	26.2	18.8
Personal saving	6.4	.6	-2.6
Federal Government sector:			
Receipts	8.2	15.4	15.4
Expenditures	7.1	13.3	4.9
Purchases of goods and services:			
National defense	2.5	4.4	1.0
Other	1.1	2.0	.6
Other expenditures	3.6	6.8	3.3
Surplus or deficit (-)	1.1	2.0	10.6

Source: Economic Report of the President, 1969

The growth in final sales decelerated, and inventory accumulation, which fell in the third quarter, ended the year at a rate little different from the high attained in the second quarter.

In the second half of 1968, the advance in GNP was not encouraged by the government sector. Federal purchases of goods and services rose $2 billion and other Federal expenditures increased $3 billion. At the same time, the surtax was withdrawing over $10 billion from the private economy. By the fourth quarter, the Federal budget was essentially in balance.

The actions of business fixed investment and homebuilding in the second half of 1968 picked up rapidly. Also, consumer expenditures advanced markedly--$18.5 billion between the second and fourth quarters. This increase was much less than that in the first half of the year.[1]

As a reflection of these indications of continuing expansion, the unemployment rate dropped to a fifteen year low, 3.4 per cent.

As the CEA looked back on economic activity in 1968, they found little cause for cheering:[2]

> In retrospect, 1968 is seen as a year of excessively rapid expansion throughout. Yet, there was a noticeable difference between the pace of advance in the first half of the year and that in the second half. The growth rate of real GNP slowed markedly from 6.5 per cent early in the year to 4 per cent by year end.
>
> Still, a much more pronounced change of pace in activity was expected as well as desired. As of midyear, many Government and private economists expected that the advance of GNP in the second half of the year might be roughly half of the $42 billion gain for the first two quarters. The enactment of the fiscal program was one--but only one--of the elements underlying that expectation. Most of the slowdown was expected to result from a lessening of demand in the private sector--steel and other inventories and homebuilding.

---

[1]Ibid., p. 42.

[2]Ibid., p. 45.

In point of fact, several elements of private demand showed unanticipated strength. The sluggishness of consumer buying in the early spring months proved to be temporary and misleading. Business fixed investment began to move up sharply from its previous plateau. Homebuilding rebounded very strongly and promptly following the easing of credit conditions. And, the strength of consumer demand in the summer contributed to a stepup in production and ordering and subsequently to rising inventory accumulation. All of these elements taken together amounted to an unexpected buoyancy in private demand and production.

While there is no clear way to tell how much the fiscal program moderated these forces, it is perfectly plausible that in the absence of fiscal restraint there would have been no deceleration whatsoever in the second half (unless, of course, the alternative of severe monetary restraint had been applied).

It is too early in the life of the surtax to pass final judgment. Surely it has not had the impact that the Administration expected. By all accounts, it was believed that at the beginning of 1969 it would exert a major impact early in the year.[1] The first quarter developments indicate that the impact has not been significant. Industrial output in March, 1969, increased 4.6 from March, 1968. Personal income also advanced rapidly in February and March of 1969.[2]

There has been one encouraging indicator in the first quarter --corporate profits. They posted a strong increase of 7.8 per cent, but it was considerably less than the 11.1 per cent increase during the first period of 1968.[3]

The economy has in fact resisted the restraining influences of the surtax; as a result, the Johnson Administration and the new Nixon Administration have both recommended that it be extended another year. Nevertheless, whatever lack of success the surtax has had as stabilization policy, the economy would have been in a much worse condition

---

[1] Ibid., p. 55.

[2] Wall Street Journal, April 13, 1969, p. 3.

[3] Wall Street Journal, April 28, 1969, p. 1.

without it.

The Johnson Administration has said that the surtax is a mirror-image of the tax cuts of 1964. If this is true, the question arises as to why the surtax has not had as much success in moderating the economy as the tax cuts had in expanding it. A partial answer can be obtained by comparing these two types of fiscal policies.

The surtax is relatively small: The 1964-65 cut amounted to $11 billion in liabilities--$6.7 billion at the beginning of 1964 and the rest at the beginning of 1965. It was about 2.5 per cent of disposable personal income, while the surtax of $6.9 is only about 1.1 per cent of disposable personal income for fiscal 1969.[1] Almost the entire impact of the 1964-65 tax reduction was felt in early 1964 when withholding rates were cut from 18 per cent to 14 per cent of income. This cut was so large that tax collections from make-up payments were extremely high in early 1965. Yet, by then, the economy was expanding briskly so that consumption continued to expand and the saving rate dropped only temporarily. In contrast, the surtax has caused large payments in the first half of 1969 since nothing was withheld for the April to June, 1968 retroactive period of the tax.

The surtax has operated with a lag: In 1964, the tax cut's stimulus to consumption was relatively prompt, in part because the reduction had been anticipated. In 1968, however, much of the impetus in the economy was so endemic that it could not be immediately removed. Anticipatory borrowing and spending diluted the immediate effects of the surtax.

---

[1]Andrew F. Brimmer, "Monetary Policy and Economic Stability," (speech presented to the Tenth Annual Meeting of the National Association of Business Economists, September 27, 1968), p. 8.

The surtax is an upper-income tax: The 1964-65 tax cut was quite helpful to people at the bottom end of the taxable income range. The new minimum standard deduction reduced drastically the liabilities of many low-income taxpayers from income taxes, and the first bracket rate was cut sharply. This undoubtedly increased the stimulating effects of the cut. By contrast, the surtax is most effective at higher income levels where people have more latitude about spending or saving. Married couples who pay less than $290 of taxes are exempt and graduated rates apply to those in immediately higher tax brackets. This is likely to increase the lag--if not the ultimate effectiveness --of the surtax.

Savings may be cut rather than spending: Because of the recent high rates of saving, there may be a greater tendency for the tax increase to reduce the rate of saving than would usually be the case. However, it is only reasonable to assume that the tax increase will reduce the dollar amount of spending much more than it does saving.

Many of the critics of the fiscal program that the Revenue and Expenditure Control Act of 1968 entails put too much emphasis on the surtax and too little on the other components of the Act. In particular, the leveling out of Federal expenditures should be assigned significant weight, since it has an immediate and direct effect on income.

CHAPTER V

CONCLUSION

A comparison of the two revenue acts, although simple enough to construct, fails to provide a meaningful answer to the problem of economic stabilization. It is not a question of the failure of an activist fiscal policy to work; it is primarily a question of how much unemployment is necessary before inflation is quelled. This is not an easy question to answer. As has been shown, political fortunes have been lost with an inappropriate answer and, in a less pragmatic sense, the economy can suffer.

At the end of 1968, the rate of unemployment was about 3.4 per cent, while the rate of inflation was in excess of 4 per cent. This unemployment rate was considerably below the 4.8 average of 1948-67 and the inflation rate considerably above the 1.7 per cent average for the same period.

A decision has to be made concerning the future rate of inflation. One way of putting the choice is to ask whether the objective should be to maintain the present 4 per cent plus rate of inflation, to return to the postwar average of approximately 2 per cent, or to reduce the rate to zero.

There is no doubt that the government can, if so determined, achieve any of these inflation rates, including zero, on the average over a period of years. The means are at hand in monetary and fiscal policy to regulate the rate of growth of total money spending, which,

in turn, controls the prices at which output oan be sold and the wages at which labor can be employed.

The primary question is what the consequences of these choices would be for the rate of unemployment. While there is much doubt and controversy about this subject, a few important points seem well established. There will be an interval during which unemployment will be higher if the inflation rate is reduced to 2 per cent rather than permitting it to oontinue at 4 per cent, and the unemployment rate will still be higher if the inflation rate is cut to zero. The difference between 4 per cent and 2 per cent inflation, in terms of unemployment during this interval, will be smaller than the difference between 2 per cent inflation and zero. Also, the difference in the unemployment rates will be smaller the more gradually the lower rate of inflation is approached. With the passage of time, the differences in unemployment rates associated with differences in inflation rates will diminish.

After several years of rapid inflation, from 1965 to 1968, there is a strong built-in tendency for prices and wages to continue rising rapidly. Some wages and prices are still catching up with price and cost increases that oocurred earlier, and some are being raised in the expectation of more inflation to come. If the rate at which total spending grows is held down to stem inflation, pressures from businesses and workers will continue to push up prices and wages and this will curtail sales, reduce output, and increase unemployment. However, these developments should, in time, moderate business and labor pressures so that prices and wages rise less rapidly, thus further discouraging compensatory price and wage demands. If total spending continues to grow steadily at its new lower rate, the rate of unemployment will diminish.

Experience with 4 per cent inflation is still fairly new, so that although price and wage decisions are being made in response to it and to the expectation that it will continue, these expectations cannot be solidly entrenched. For example, labor and management have probably not come to think of 6 per cent annual wage increases as normal; therefore, it may not take much slack in the economy to re-adjust wage and price behavior to be compatible with a lower rate of inflation.

If moving from a 4 per cent rate of inflation to, say, a 2 per cent rate is economically possible, is it politically feasible? The answer to that appears to be no. Such a transition would take at least three to five years, during which the unemployment rate would increase significantly, perhaps 2 to 3 per cent. Such a move would involve the concerted efforts of an entire Presidential administration. The political structure, tied inexorably to high employment, would react as it has done since 1954--it would remove from office any administration committed to such a policy.

In view of these political realities, the Revenue and Expenditure Control Act of 1968 will be perhaps as much of a success as the Revenue Act of 1964. It represents a compromise in the best political tradition. It will contribute to economic stability without a disruptive effect on unemployment. To be sure, it fails to solve the causes of inflation and excessive growth, but these are causes with which an active fiscal policy is ill-prepared to deal. An active fiscal policy is able to arrest inflationary increases, but it cannot and should not be required to contract an economy as well as it can expand it.

BIBLIOGRAPHY

Books

Ackley, Gardner. Macroeconomic Theory. New York: The Macmillan Co., 1961.

Adams, Sherman. Firsthand Report. New York: Harper and Co., 1961.

Burns, Arthur F. Prosperity Without Inflation. Garden City, N.Y.: Doubleday and Co., 1958.

Donovan, Robert J. Eisenhower, the Inside Story. New York: Harper and Co., 1956.

Eisenhower, Dwight D. Mandate for Change. New York: Doubleday and Co., 1963.

Eisenhower, Dwight D. Waging Peace. New York: Doubleday and Co., 1965.

Harris, Seymour H. The Economics of the Kennedy Years. New York: Harper and Row, 1964.

Heckman, Bert G. Growth and Stability of the Postwar Economy. Washington, D.C.: Brookings Institution, 1960.

Heller, Walter W. New Dimensions of Political Economy. New York: W. W. Norton & Co., Inc., 1967.

Keynes, John Maynard. The General Theory of Employment, Interest, and Money. New York: Harcourt, Brace, and World, Inc., 1936.

Lekachman, Robert. The Age of Keynes. New York: Random House, 1966.

National Industrial Conference Board. Economic Almanac. New York: Macmillan Co., 1968.

Samuelson, Paul A. Economics. New York: McGraw-Hill Book Co., 1967.

Sundquist, James L. Politics and Policy. Washington, D.C.: Brookings Institution, 1968.

Tobin, James, ed. Economic Issues of the 60's. Boston: McGraw-Hill Book Co., 1960.

Public Documents

U.S. Congress. House Committee on Ways and Means. Hearings on the Tax Recommendations of the President, 1963. 88th Cong., 1st Sess., 1963.

U.S. Congress. House Committee on Ways and Means. Hearings on Tax Proposals of the President, 1967. 90th Cong., 1st Sess., 1967.

U.S. Congress. House Committee on Ways and Means. Hearings, Continuation to Receive Further Administration Proposals Concerning Expenditure Cuts. 90th Cong., 1st Sess., 1967.

U.S. Congress. Joint Economic Committee. Hearings, Fiscal Policy Issues of the Coming Decade. 89th Cong., 1st Sess., 1965.

U.S. Congress. Joint Economic Committee. Report of the Joint Economic Committee on the January, 1959 Economic Report of the President. 86th Cong., 1st Sess., 1959.

U.S. Congress. Joint Economic Committee. Hearings, Twentieth Anniversary of the Employment Act of 1946 - an Economic Symposium. 89th Cong., 2nd Sess., 1966.

U.S. Congress. Senate Finance Committee. Hearings, Investigation of the Financial Condition of the United States. 85th Cong., 2nd Sess., 1958.

U.S. Congressional Record. Vol. C.

U.S. Congressional Record. Vol. CIV.

U.S. President. Economic Report of the President, 1954. Washington, D.C.: Government Printing Office, 1954.

U.S. President. Economic Report of the President, 1955. Washington, D.C.: Government Printing Office, 1955.

U.S. President. Economic Report of the President, 1964. Washington, D.C.: Government Printing Office, 1964.

U.S. President. Economic Report of the President, 1966. Washington, D.C.: Government Printing Office, 1966.

U.S. President. Economio Report of the President, 1968. Washington, D.C.: Government Printing Office, 1968.

U.S. President. Economic Report of the President, 1969. Washington, D.C.: Government Printing Office, 1969.

U.S. President. Public Papers of the President, 1953. Washington, D.C.: Government Printing Office, 1954.

U.S. President. Public Papers of the President, 1954. Washington, D.C.: Government Printing Office, 1955.

U.S. President. Public Papers of the President, 1958. Washington, D.C.: Government Printing Office, 1959.

U.S. President. Public Papers of the President, 1961. Washington, D.C.: Government Printing Office, 1962.

U.S. President. Public Papers of the President, 1962. Washington, D.C.: Government Printing Office, 1963.

Articles and Periodicals

"Monetary Policy in the 1960's." Federal Reserve Bulletin, September, 1968, pp. 700-14.

"Nation's Business." Time, December 30, 1957, pp. 53-55.

Somers, Harold M. "Special Comment--The Great Tax Battle--A National 'Trust' Fund." Los Angeles Times, August 17, 1967.

Stevenson, Adlai. "What I Think." Harper's, October, 1956, p. 92.

Wall Street Journal. April 13, 1969, p. 3.

Wall Street Journal. April 28, 1969, p. 1.

"Why a Tax Cut is Unlikely in '63." U.S. News and World Report, December 17, 1962, pp. 42-45.

"Wilbur Mills Makes a Point." Wall Street Journal, October 10, 1967.