penditures, and so approach a balanced budget with some surplus for debt reduction (see Appendix I).

Substantial emphasis on monetary policy, both of a general nature and consideration, at least, of specific controls (over consumer credit), was also characteristic of this period.

Assorted policies to promote economic growth included measures to strengthen competition, promote thrift, and improve human and natural resources. Such recommendations can be found in all the Economic Reports of the President.

It is evident from Table 2 that in the 1955-57 expansion the total effect of Federal government finances as reflected in the cash budget was restrictive, and more so than had been expected. During the early part of the expansion (fiscal 1956) the actual surplus far exceeded the budget estimate. However, in the latter part of the expansion (fiscal 1957) the actual surplus fell short of the budget estimate. When the subsequent recession approached its trough (in mid-1958), the estimated surplus turned into a deficit.

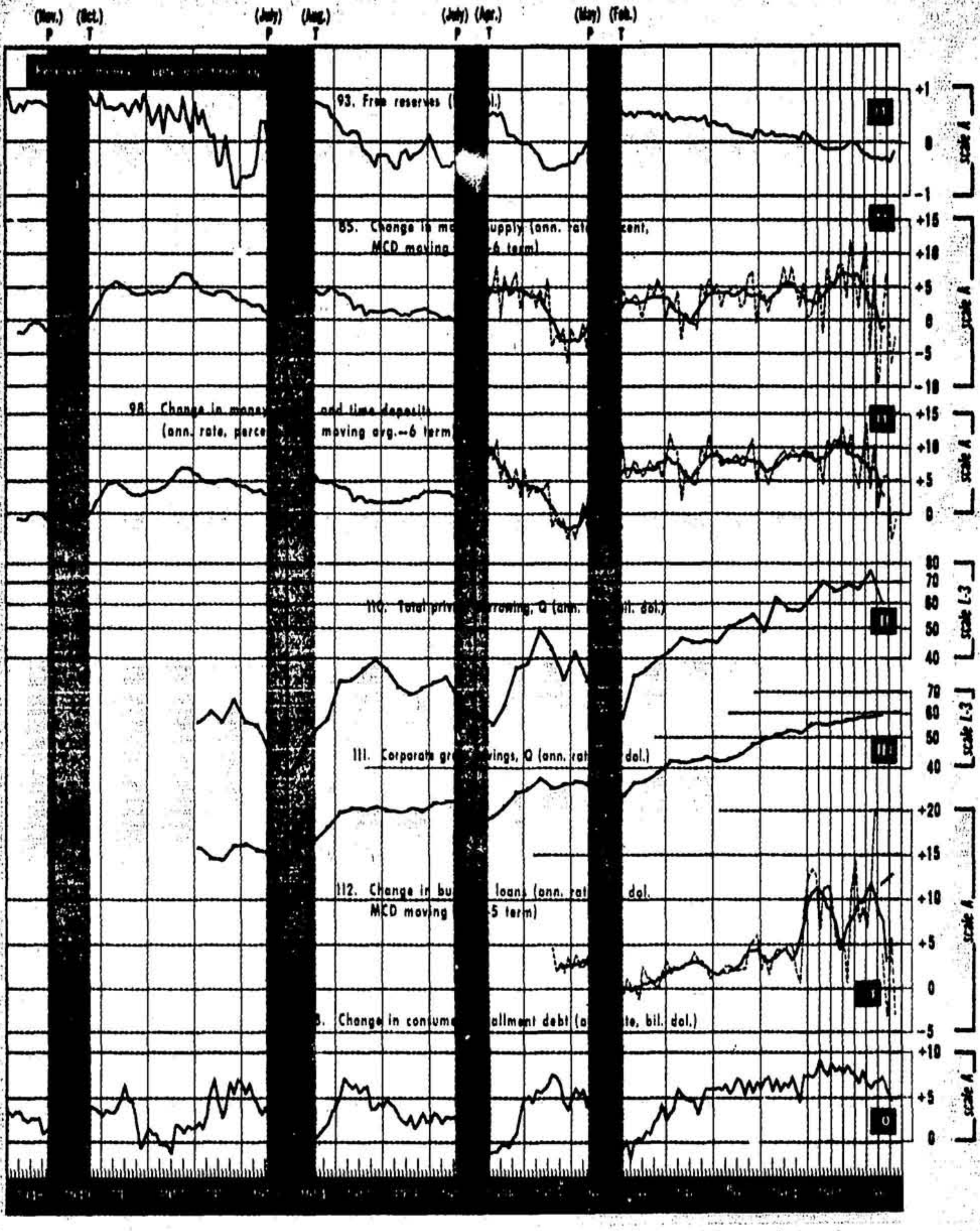
It is also notable that in these years the cash surplus substantially exceeded the administrative budget surplus. From World War II until 1958 the trust funds showed a sizable cash surplus which added to the restrictive effects of Federal operations.

This business expansion reached its peak in July 1957. Major discretionary actions taken to check inflationary pressures, which were substantial, were in the monetary area. As shown by Chart 3, the "free reserves" (total reserves for bank deposists less borrowings at the Federal Reserve Banks) of the banking system were sharply reduced in calendar 1955 to negative amounts. The increase in the money supply was held to minimal levels through 1956 (about one percent over the year), and both short- and long-term interest rates rose sharply (Chart 2).

One major issue of this period concerned the causes of the inflation that was occurring. On the one hand, many argued that with an unemployment rate of 4 percent or more, it was not excessive aggregate demand that was causing inflation, but rather the "cost-push" of rising wage rates and "administered prices." It was also argued that the relatively high level of unemployment was a reflection of "structural unemployment" — unemployment attributable to such things as geographical and occupational immobility in the labor force — so that increased aggregate demand was not the appropriate cure. Rather, measures were needed to meet unemployment in those particular areas which had been hard hit by changes in industry and to train unemployed for the kinds of jobs available.

The Recession of 1958. Since economic activity had begun to decline in the latter part of 1957, one might have expected that the Budget for 1959 (presented in January 1958) would have included discretionary measures to meet the recession. Increasing defense needs incidentally provided some stimulus, and nondefense expenditures rose substantially but not on the basis of initial budget requests. On the tax side, no changes were recommended and further extension of Korean War rates was again requested. A surplus of $466 million was estimated in the Budget for fiscal 1959. In fact, mainly as a result of the recession, the actual deficit was $12.4 billion, the largest in the post-World

Chart 3
FREE RESERVES, CHANGE IN MONEY SUPPLY, AND OTHER SELECTED FINANCIAL SERIES
Monthly 1948-1966



Note: Scales "L" are logarithmic; scales "A" are arithmetic.
Shaded areas are periods of recession. "P" = peak. "T" = trough.

Source: Reproduced from U.S. Department of Commerce, Business Cycle Developments.

Table 3

Original Estimates of Surpluses (+) or Deficits (—) In Administrative and Cash Budgets Compared with Actuals

Fiscal Years 1959-1961 (Millions)

Year	Administrative Budget(a)		Cash Budget(b)	
	Original Estimate	Actual	Original Estimate	Actual
1959	$+ 466	$−12,427	$+ 624	$−13,092
1960	+ 70	+ 1,224	+ 626	+ 750
1961	+4,184	− 3,856	+5,921	− 2,300

a. Excludes trust funds.
b. Consolidated cash receipts from and payments to the public.

Source: Bureau of the Budget.

War II period. Receipts fell short of the budget estimates by $6.1 billion while expenditures exceeded the budget estimate by $6.8 billion. These "errors" occurred despite the fact that the level of GNP assumed in the budget was within one percent of the actual for the calendar year 1958.

Thus, without significant discretionary action on the tax side, the Federal budget provided a large stimulus to economic expansion in this recession.

Changes in monetary policy were substantial – increased bank reserves contributed to sharp declines in interest rates, which were accompanied by reductions in the discount rate at Reserve Banks. However, it is notable that the trough in the recession had barely passed before interest rates again rose sharply, and free reserves were reduced to a zero level at the end of calendar 1958. The fear of another inflationary expansion similar to that of 1955-57 apparently affected Federal Reserve action.

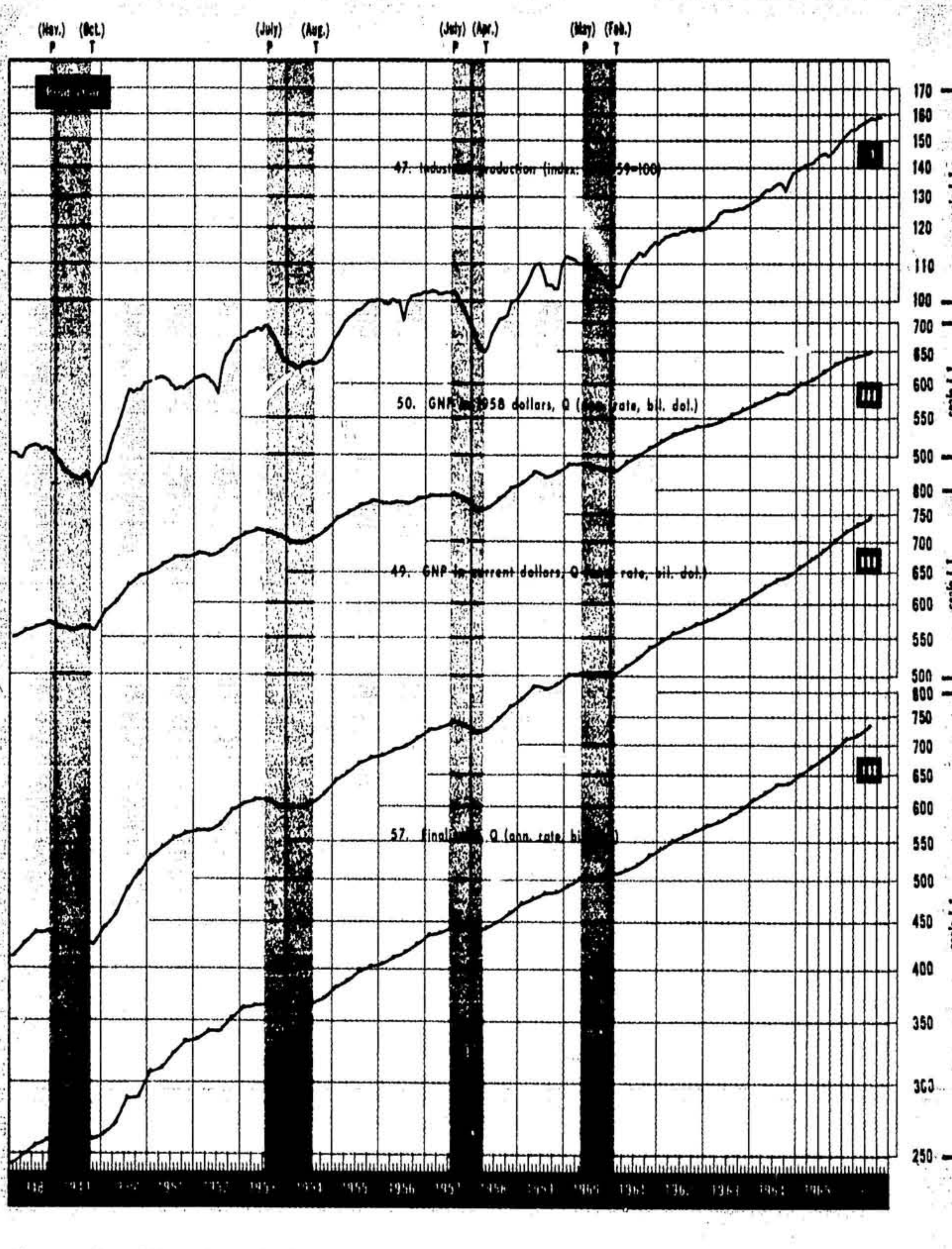
This sharp turn in monetary policy contributed to the criticism that in the expansion of 1959 restrictive policies were overdone with the result that expansion came to a premature end.

The Expansion of 1959. The Federal budget for fiscal 1960, presented in January 1959, again contained no major recommendations for changes in either taxes or expenditures. It estimated a slim surplus of $70 million for fiscal 1960.

In fact, actual receipts exceeded the estimate by $1.4 billion, and the budget for 1960 showed a surplus of $1.2 billion. This was a sharp reversal from the $12 billion deficit of fiscal 1959, and it gave rise to criticism that the shift in policy had been too sharp and operated to limit the expansion prematurely. Restrictive monetary policy was carried to the point that the money supply actually declined in the latter part of 1959 (Chart 3, p. 17).

The peak of the expansion was reached in the second quarter of calen-

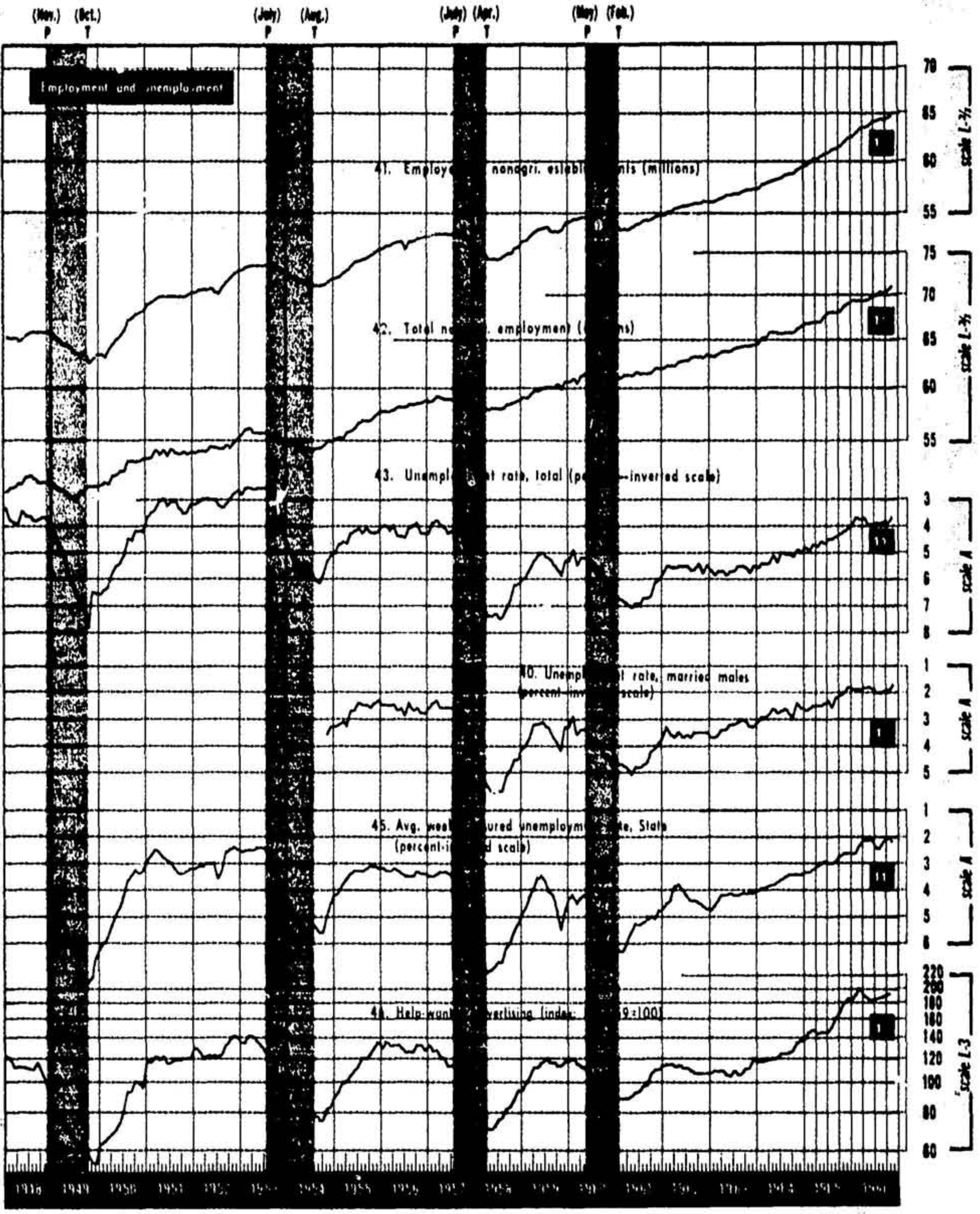
Chart 4
INDEX OF INDUSTRIAL PRODUCTION, GROSS NATIONAL PRODUCT IN CURRENT AND CONSTANT DOLLARS
Quarterly 1948-1966



Note: Scales "L" are logarithmic; scales "A" are arithmetic.
Shaded areas are periods of recession. "P" = peak. "T" = trough.

Source: Reproduced from U.S. Department of Commerce, **Business Cycle Developments.**

Chart 5
TOTAL EMPLOYMENT, UNEMPLOYMENT RATE, AND HELP-WANTED ADVERTISING
Monthly 1948-1966



Note: Scales "L" are logarithmic; scales "A" are arithmetic.
Shaded areas are periods of recession. "P" = peak. "T" = trough.

Source: Reproduced from U.S. Department of Commerce, **Business Cycle Developments.**

dar 1960. During the remainder of calendar 1960 industrial production and gross national product remained stable in current dollars but declined in constant dollars (Chart 4).

This relatively quick ending of the expansion provided one of the issues of the 1960 election campaign – the issue of whether the country's rate of economic growth could be increased and made more stable. Defenders of the actions of the Eisenhower Administration claimed, with apparent justification, that the inflationary psychology of the 1955-57 period had been largely eliminated and that the stability reached in the price level was a major achievement.

One observer described this episode in counter-cyclical policy as follows:

> It was in this setting [of recent inflationary experiences] that President Eisenhower decided that strong measures were needed if the inflationary psychology, which had been built up over the years, was to be curbed before it caused lasting damage to our economy and to our international political position. Between the first quarter of 1959 and the second quarter of 1960 the Federal cash budget shifted from a deficit at an annual rate of $15 billion, to a surplus of $5 billion, and this enormous fiscal swing was accompanied by sharp monetary restraints. Much may be said in criticism of the restrictive economic policy of that time . . . But it is also worth remembering that the highly restrictive policy of 1959 and early 1960 served a historic function, that it routed a dangerous inflationary psychology, that it demonstrated that ours need not be an age of inflation . . . and that it thus laid the foundation for the long stretch of expansion that we have been experiencing.[11]

The Recession of 1960. The recession that began in the second quarter of 1960 was relatively mild and short-lived. The unemployment rate rose to nearly 7 percent in mid-1961 but thereafter fell to about 5½ percent where it remained until 1964 (Chart 5). Treasury bill rates fell to less than 2½ percent and Treasury bond yields remained stable at about 4 percent. The money supply (especially if time deposits are included) rose sharply (Chart 3).

A special feature of this period was the emergence of the balance of payments deficit as a major problem which constituted a serious restraint on further easing of monetary conditions.[12] An innovation in policy was "operation twist," the objective of which was to hold up short-term interest rates to check outflows of short-term capital to other countries, but to maintain long-term interest rates at current levels so as to avoid checking domestic investment.[13] This operation was apparently successful in changing the relationship of short- and long-term interest rates – putting them both at nearly the same level (Chart 2). However, it is difficult to say how effective higher short-term rates were in checking the outflow of funds. In any case, many other measures were resorted to in an effort to meet the balance of payments problem without at the same time imposing restraints on domestic economic expansion.

The Expansion of 1961-66. This period is notable for a shift in policy to what has been labeled the "New Economics." President Kennedy's first *Budget Message,* however, seems almost identical in emphasis to those of the last Eisenhower years. (The last Eisenhower budget was presented in January 1961.)

11. Arthur F. Burns, "Our Longest Expansion," *Tax Review*, Vol. 26, No. 11, November 1965, p. 47.
12. For discussion of the balance of payments problem see below p. 33.
13. The "bills only" doctrine was officially abandoned in February 1961. (*Annual Report of the Board of Governors of the Federal Reserve System 1961*, pp. 39, 40.)

The *Budget* presented in January 1962 showed an estimated cash surplus for fiscal 1963 of $1.8 billion. In the national income accounts, the estimated surplus for the Federal sector was $4.4 billion. The *Budget Message* said in part: "To plan a deficit under such circumstances [of rising economic activity] would increase the risk of inflationary pressures, damaging alike to our domestic economy and to our international balance of payments."

The *Economic Report of the President* in January 1962 was more of an innovation. It was notable for its greatly increased length – 27 pages. It was not merely a brief letter of transmittal sending the CEA's Report to Congress. This *Report* emphasized the goal of maximum production and employment in terms of a "full-employment GNP," which was estimated at $600 billion. The emphasis of fiscal policy was on increased expenditures, partly as a result of the recession of 1960-61, but also because "major increases in expenditure for national security and space programs became necessary." (Chart 6.) The fiscal policy position was summed up as follows:

> In a fully employed economy, these increases would have required new tax revenues to match. But I did not recommend tax increases at this point because they would have cut into private purchasing power and retarded recovery. (page 6)

This *Economic Report* was specific in setting out a goal of economic growth:

> We have not in recent years maintained the 4 to 4½ percent growth rate which characterized the early postwar period. We should not settle for less than the achievement of a long-term growth rate matching the early postwar record. Increasing our growth rate to 4½ percent a year lies within the range of our capabilities during the 1960's. (page 9)

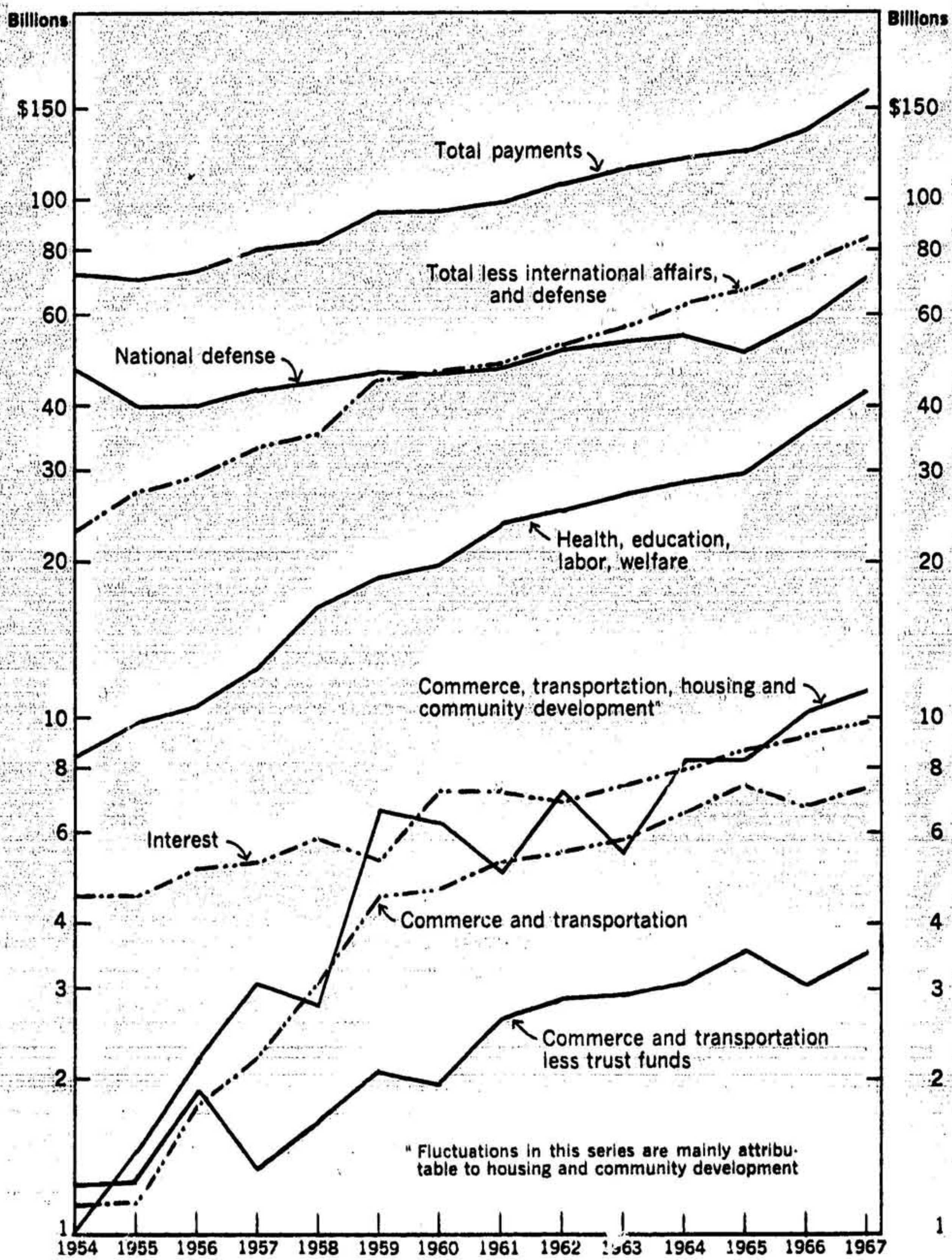
Two major policies adopted to stimulate growth in 1962 were the investment tax credit, which reduced the net cost of business equipment, and new depreciation guidelines, which replaced the obsolete rules for determining "useful lives" carried over from the 1930's. These measures were "structural" tax changes rather than general rate changes intended to affect the level of total revenues.

Another innovation in 1962 was the concept of the "full-employment budget." Although early post-World War II budgets had emphasized the "nation's economic budget," which was a formulation of Federal operations in terms of the national income accounts, this form of the budget had not been used in Budget Messages for many years. It reappeared in the President's Messages in 1962 in the form of the "full-employment surplus." While the concept was developed in more detail in the CEA's *Report*, it was stated in general terms in the President's *Report* as follows:

> A surplus of $4.4 billion in fiscal 1963 is expected in the national income accounts budget—a budget constructed to measure the direct impact of Federal expenditures and receipts on the flow of total spending. The surplus would be several billion dollars higher if the economy were operating steadily at a level high enough to hold unemployment to 4 percent. (page 12)

According to the CEA, "The full-employment surplus is a measure of the restrictive or expansionary impact of a budget program on over-all demand." However, estimating what GNP would be at "full employment" and, in turn, estimating what Federal receipts and expenditures would be at that level of

Chart 6
FEDERAL PAYMENTS TO THE PUBLIC BY MAJOR FUNCTION
Fiscal Years 1954-1967



Source: U.S. Bureau of the Budget.

GNP involves numerous assumptions and leaves much room for professional differences of opinion.

The full-employment budget may be regarded as one more step in the development of statistical analysis of the effects of Federal operations. It certainly will not be the last.

The related concept of "fiscal drag" refers to the tendency for a progressive tax structure to impose an increasing check to economic growth as a period of expansion continues. This concept provided part of the argument for the tax reduction of 1964.

The CEA's *Economic Report* for 1962 also for the first time set out the widely-debated "guideposts for noninflationary wage and price behavior." Although previous *Economic Reports* for many years had discussed in general terms the relation between wages, prices and productivity, the 1962 *Report* was the first to propose in specific terms guides for "appraising wage and price behavior." The guides were summed up in this report as follows:

> The general guide for noninflationary wage behavior is that the rate of increase in wage rates (including fringe benefits) in each industry be equal to the trend rate of over-all productivity increase. General acceptance of this guide would maintain stability of labor cost per unit of output for the economy as a whole — though not of course for individual industries.
>
> The general guide for noninflationary price behavior calls for price reductions if the industry's rate of productivity increase exceeds the over-all rate — for this would mean declining unit labor costs; it calls for an appropriate increase in price if the opposite relationship prevails; and it calls for stable prices if the two rates of productivity increase are equal.
>
> These are advanced as general guideposts. To reconcile them with objectives of equity and efficiency, specific modifications must be made to adapt them to the circumstances of particular industries . . . (page 189)

In the *Budget Message* for 1964 (presented January 1963) the emphasis on the "gap" between actual and potential GNP was carried further, and the restrictive effects of the tax system were identified as one of the major causes of the "shortfall" in output. In this message, President Kennedy proposed an extensive program of tax reduction and reform to stimulate the economy and improve the tax structure. "The checkrein of taxes on private spending and productive incentives must be loosened if our economy is to perform at maximum efficiency" (page 8). This was a notable change from the first Kennedy Budget Message.[14]

The new element in this proposal was the deliberate adoption of an increased deficit: ". . . . the immediate effect of my proposed tax program will be to increase the deficit which would otherwise be incurred in the coming fiscal year."

It is unnecessary here to review the extensive discussions of the estimated effects which the tax reduction was expected to have on the economy and in turn on Federal revenues.[15] At any rate the expansion of the economy exceeded the CEA forecast (Table 6, p. 40), and the actual deficit in the Federal cash budget for fiscal 1964 was only about half of the original estimate (Table 4).

The *Budget Message* for fiscal 1965, the first presented by President Johnson,

14. For an inside story of the change in President Kennedy's views, see Walter Heller, *New Dimensions of Political Economy*, (Cambridge: Harvard University Press, 1966).

15. Details can be found in the *Hearings* before the Joint Economic Committee on the *January 1963 Economic Report of the President*, Part 1, especially pages 12-25.

again brought a shift of emphasis in economic policy goals:

> This budget makes provision for the initiation of new and major effort to break the vicious circle of chronic poverty. . . . We owe to every young person in America a fair start in life — and this means that we must attack those deficiencies in education, training, health, and job opportunities by which the fetters of poverty are passed on from parents to children.

The launching of the "Great Society" programs in 1964 and 1965, combined with excise tax reductions, continued the stimulative fiscal policies of the Kennedy Administration. However, the expansion of the Vietnam war in the summer and fall of 1965, combined with the apparent success of earlier policies in bringing the economy close to full employment, raised the problem of inflation. Signs of price increases that were greater than "normal" appeared in the summer of 1965 (see Chart 7) and there were wide differences in estimates of the extent to which the expanded war effort in Vietnam would increase defense expenditures.

The *Budget Message* for fiscal 1967 requested selective tax measures as a restraining influence on the economy. The scheduled reductions in the automobile and telephone excises were rescinded, and several billion of additional collections were obtained from speed-ups of corporate and individual income tax payments under the Tax Adjustment Act of 1966.

Issues widely debated in the spring of 1966 were the questions of the need for a general tax increase for anti-inflationary purposes, the feasibility and desirability of further monetary restraint, and checks on Federal expenditures as alternatives to tax increases. In the meantime, the Administration proceeded

Table 4

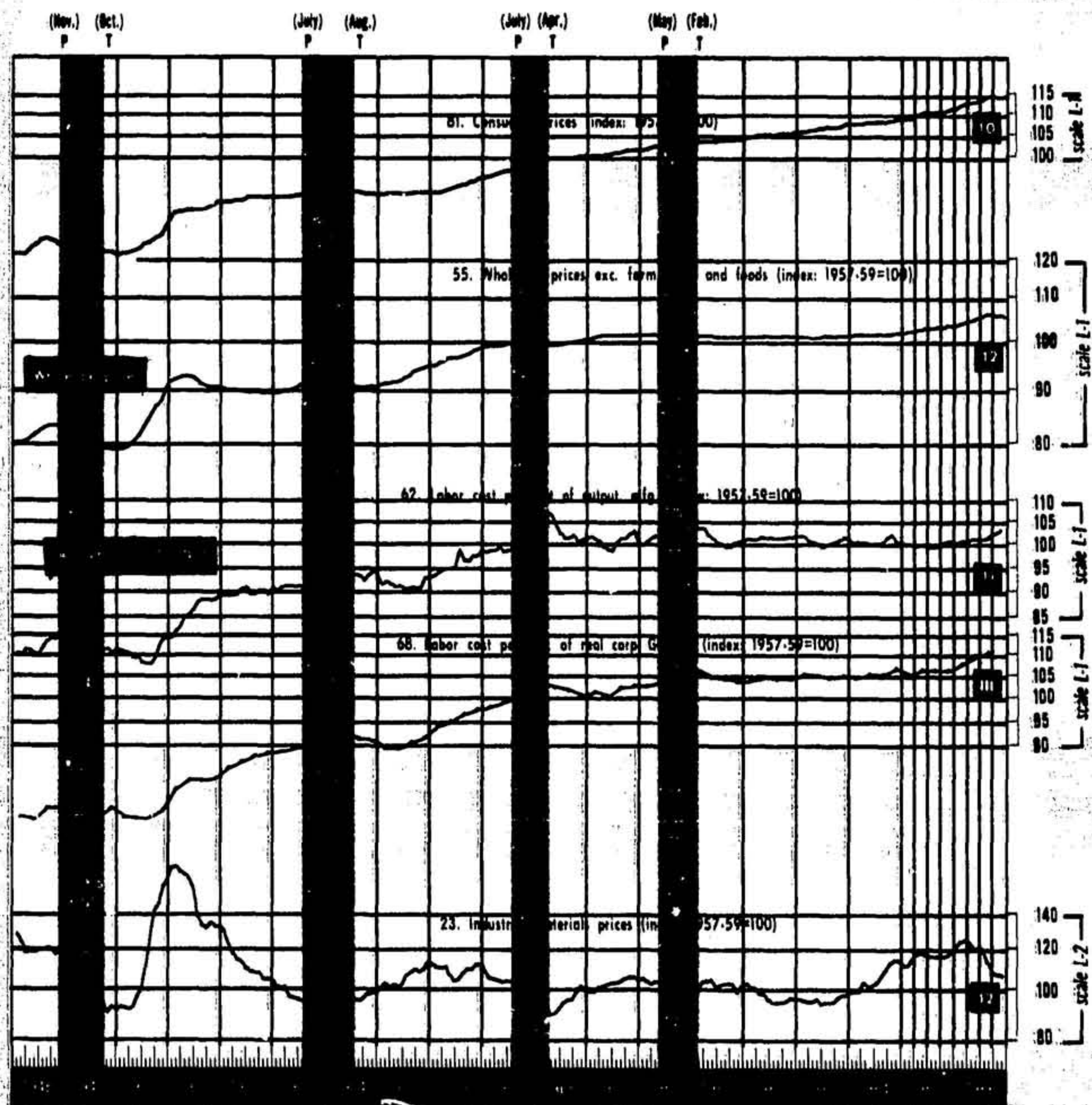
Original Estimates of Surpluses (+) or Deficits (—) in the Administrative and Cash Budgets Compared with Actuals

Fiscal Years 1962-1966
(Millions)

	Administrative Budget(a)		Cash Budget(b)	
Year	Original Estimate	Actual	Original Estimate	Actual
1962	$+ 1,468	$ −6,378	$+ 1,313	$ −5,797
1963	+ 463	−6,266	+ 1,810	−4,012
1964	−11,902	−8,226	−10,281	−4,802
1965	− 4,300	−3,474	− 2,948	−2,696
1966	− 5,287	−2,286	− 3,908	−3,210

a. Excludes trust funds.
b. Consolidated cash receipts from and payments to the public.
Source: Bureau of the Budget.

Chart 7
INDEXES OF CONSUMER PRICES, WHOLESALE PRICES, INDUSTRIAL MATERIALS PRICES, AND LABOR COST PER UNIT OF OUTPUT
Monthly 1948-1966



Note: Scales "L" are logarithmic; scales "A" are arithmetic.
Shaded areas are periods of recession. "P" = peak. "T" = trough.

Source: Reproduced from U.S. Department of Commerce, **Business Cycle Developments.**

Table 5

Comparison of Original Federal "Cash Budget" Estimates with Actual Receipts from, Payments to the Public, and Surplus or Deficit

Fiscal Years 1955-1966
(Amounts in Mililons)

	Receipts				Payments(a)				Surplus (+) or Deficit (—)	
			Estimate less actual				Estimate less actual			
Year	Estimate	Actual	Amount	Percent of actual	Estimate	Actual	Amount	Percent of Actual	Estimate	Actual
1955	$ 70,842	$ 67,836	$+ 3,006	+ 4.4%	$ 70,727	$ 70,537	$+ 190	+ .3%	$+ 115	$− 2,702
1956	68,793	77,087	− 8,294	−10.8	68,235	72,546	− 4,311	−5.9	+ 558	+ 4,452
1957	75,354	82,106	− 6,752	− 8.2	72,920	80,006	− 7,086	−8.9	+ 2,434	+ 2,099
1958	85,923	81,892	+ 4,031	+ 4.9	82,970	83,472	− 502	− .6	+ 2,953	− 1,580
1959	87,286	81,660	+ 5,626	+ 6.9	86,662	94,752	− 8,090	−8.5	+ 624	−13,092
1960	93,502	95,078	− 1,576	− 1.7	92,875	94,328	− 1,453	−1.5	+ 626	+ 750
1961	102,178	97,242	+ 4,936	+ 5.1	96,257	99,542	− 3,271	−3.3	+ 5,921	− 2,300
1962	103,145	101,865	+ 1,280	+ 1.3	101,832	107,662	− 5,877	−5.5	+ 1,313	− 5,797
1963	116,614	109,739	+ 6,875	+ 6.3	114,804	113,751	+ 1,053	+ .9	+ 1,810	− 4,012
1964	112,196	115,530	− 3,334	− 2.9	122,477	120,332	+ 2,145	+1.8	−10,281	− 4,802
1965	119,742	119,699	+ 133	+ .1	122,690	122,395	+ 295	+ .2	− 2.948	− 2,696
1966	123,490	134,382	−10,892	− 8.1	127,398	137,592	−10,194	−7.4	− 3,908	− 3,210
Average of percentage differences between estimates and actuals[b]				5.1				3.7		

a. Estimates were not adjusted for certain minor statistical revisions in actual payments to the public. These statistical revisions were not large enough to affect the percentage "errors" in the estimates.

b. Simple arithmetic averages computed without regard to sign.

Source: Bureau of the Budget.

to apply exhortation and persuasion to check business investment and state-local government capital outlays. The Federal Reserve System applied still more restrictive measures, and the money supply began to decline.[16]

The long, steady expansion of the economy since 1961 (see Chart 4) seems to corroborate the emphasis of the Kennedy and Johnson Administrations on the effectiveness of fiscal policy. In this period the members of the CEA have tended to deemphasize monetary policy. As one member once remarked: "Fiscal policy can do anything that monetary policy can do, and do it more effectively both as to the volume and the composition of aggregate demand."[17] However, it is one of the significant features of this expansion that monetary policy also remained "easy" over a longer period than ever before in a period of expansion. Some economists are of the opinion that the continued high rate of increase in the money supply throughout this period (to mid-1966) was a major contributor to the continued economic expansion.

16. For the latest changes in the money supply, see *Rates of Change in Bank Reserves and Money*, Federal Reserve Bank of St. Louis (monthly).

17. Gardner Ackley, "The Economic Policies of the Kennedy Administration," address to the Midwest Economics Association, St. Louis, April 26, 1963, p. 16.

III.
Current Issues in Fiscal Policy

Fiscal policy issues change as the economic situation changes. Because of the current pressures of inflation, the emphasis here will be on the problems of containing inflation while maintaining economic growth. Because serious recessions have been rare in recent years, little attention will be given to the problems of moving out of a situation with substantial unemployment.

Fiscal policy issues may be divided into two broad groups – economic and political. There is no clear dividing line between these categories, but the division serves as a useful way of organizing discussion and analysis.

Economic Issues

The major objectives of fiscal policy are now widely accepted, namely: "full employment," general price-level stability, and a high rate of economic growth.

Major issues arise (1) when there is a conflict between major fiscal policy objectives and other national policy goals; (2) when the major economic objectives themselves are to some degree conflicting, and a choice must be made concerning the relative importance of each; (3) when alternative instruments or tools of policy, each having somewhat different kinds of effects, can be used to pursue these objectives; (4) when the nature of the economic situation and the causes of economic instalility are subject to doubt and debate.

Major Fiscal Objectives and Other National Policy Goals

In the current situation expenditures for the war in Vietnam are a major source of the pressures on the economy. Defense Department obligations rose from $46.2 billion in the first ten months of calendar 1965 to $59.7 billion in the first ten months of calendar 1966. They are expected to go still higher.

This rise in government expenditures, together with the stimulus already given to the economy by an easy money policy and the tax changes under the Revenue Acts of 1962 and 1964, produced an "inflationary gap" – an excess of total demand over the capacity output at current prices. When the total amount that the various sectors of the economy – consumers, business, and government – attempt to spend exceeds what can be produced at existing prices, the general price level is bound to rise.

The major economic problem of 1966 was how to contain inflation. If inflation continues to be a major problem in 1967, policy issues similar to those of 1966 will have to be dealt with. What combinations of measures are best suited to eliminating the inflationary gap? If inflation in 1967 turns out to be more of the "cost-push" variety, what changes in policy should be made? On the other hand, if a recession develops in 1967 (as some predict), a shift to stimulative measures will be appropriate.

It is indicative of the basic strength of the American economy that a considerable range of choice is possible in selecting anti-inflationary measures. However, basic value judgments and political issues necessarily enter into the determination of the policies chosen.

A central issue is how far the "Great Society" goals, which involve substantial increases in Federal expenditures, should be pursued at the same time as defense expenditures are rising. The Administration in 1965 and 1966 endeavored to pursue both sets of goals on the expenditure side, while minimizing the need for restrictive tax measures.

The assumption that inflationary pressures would not be strong clearly turned out to be wrong. The price level began to rise more rapidly in 1966, bringing with it the costs and burdens of inflation. The main burden of checking inflation fell to the Federal Reserve System and monetary policy. The result was record increases in interest rates and a special burden on housing construction, which is particularly sensitive to tight money conditions.

In September, in order to tighten fiscal policies and ease the pressures of tight money, the President proposed the suspension of the 7 percent investment tax credit and of accelerated depreciation on commercial and industrial buildings for a period of 16 months, combined with a cut back in "low priority" expenditure programs. He did not define exactly what expenditure programs he meant. The tax measure, with some modifications, was passed late in October. The effective date of the tax credit suspension was October 10.

The choice of this action was in part a response to the rapid rise in business investment expenditures in 1965 and 1966. However, suspension of the tax credit also meant some shift of emphasis from the long-term objective of promoting economic growth through higher capital investment.

Despite any action taken in the fall of 1966, the central issues will remain to be faced again by the Administration in the Budget for the fiscal year 1968 (presented in January 1967), and to be debated as Congress acts on the new budget.

The priority to be given to "Great Society" programs will probably be a major issue in formulating the budget. These programs consist largely of education aids, the "war on poverty," and assorted programs to ease the problems of cities and metropolitan areas. Here is where important choices must be made — as discussed below, most other expenditures are less controllable. The goals in the new programs are largely long-term: the nature of the objectives in poverty programs and urban renewal is such that they cannot be gained overnight. Consequently, it would seem reasonable to plan to stretch out these programs over a longer period. Indeed, the administrative and political problems that have arisen — partly because of the "crash approach" used — also argue for a slowdown. Waste and duplication could be reduced by a stretch-out. On the other hand, it is argued, a revolution is under way in expectations of the poor and to slow down these programs would intensify unrest and violence.

A more general fiscal issue is involved here also. That is the ability of the Administration and Congress to control expenditures for the purpose of short-run economic effects — to cut back when in-