

flationary pressures develop, and to expand during recessions without intensifying later periods of expansion. This issue is discussed further below (p. 38).

Conflicts Among Major Economic Goals

If the goals of price level stability, full employment, and increasing productivity were fully compatible, the problems of fiscal policy would be far easier to deal with. Unfortunately, measures that will reduce unemployment may also produce inflation, and measures that might cure our international balance of payments deficit might also produce a recession. Although other conflicts exist, these two are particularly worth examining in today's economic circumstances.

Inflation versus Full Employment. The issue of the so-called "trade-off" between inflation and unemployment has been a central one in fiscal policy debates. The goal of full employment, it is argued, can only be achieved at the cost of continuing increases in the general price level — the closer the economy gets to full employment, the more "bottlenecks" or shortages in particular parts of the economy put upward pressure on prices and wages. Similarly, inflationary pressures may at times reach a point such that measures to halt price level increases would produce a substantial amount of unemployment.¹

This conflict is reflected in debates over the definition of full employment and price level stability. At times an unemployment rate of four percent, or

three percent, or even less, has been taken as the measure of full employment. It now seems evident that no single rate of unemployment in the total labor force can be taken as a sufficient indicator of the need for stimulus in the economy. Changes in the components of unemployment (by age, color, industry, etc.), as well as job vacancies, and other indicators must be taken into account.

The goal of price level stability also presents problems of definition and measurement. The long-run tendency of the consumer price index to rise, in part because of the slow growth of productivity in consumer services, has led many economists to accept a small annual rise in this index as being not inconsistent with general price stability. The wholesale price index, on the other hand, has not shown the same long-run tendency to rise, but it is less relevant to family budgets than is the consumer price index.²

A considerable range of price indexes is available for making a judgment on whether or not the general price level is "stable" or rising sufficiently to characterize the situation as "inflationary" (see Chart 7).

Beyond questions of measurement, the problem of inflation involves a judgment of public psychology. If people generally become convinced that the price level will continue to rise significantly in the future, they may begin to buy goods, services, securities, and other assets, largely as a hedge against inflation

1. For a statistical analysis of this "trade-off" see "Prices: Patterns and Expectations," *Economic Review*, Federal Reserve Bank of Cleveland, April 1966. This article shows that for the period 1954-1965 a 4 percent level of unemployment was associated with a 12-month increase of about 3 percent in industrial wholesale prices. The index of industrial wholesale prices is "usually regarded as the most responsive to changes in the level of economic activity." A more detailed analysis can be found in Michael E. Levy, "Full Employment and Inflation: A 'Trade-Off' Analysis," *The Conference Board Business Record*, December 1966, pp. 17-27.

2. The consumer price index measures changes in the cost of a "market basket" of goods and services typically purchased by urban families of wage and clerical workers. It measures changes in *prices*, not changes in the "cost of living" that may result from changes in the composition of family purchases as well as from changes in prices. For a recent examination, see U.S. Congress, Joint Economic Committee, *Inflation and the Price Indexes*, materials submitted to the Subcommittee on Economic Statistics (Washington, D.C.: Government Printing Office, July 1966).

— to avoid having to pay higher prices later on, or to make a profit by selling assets at a higher price level in the future. If an inflationary outlook becomes widespread among the public, upward pressures on prices will be self-reinforcing. During periods of war or prospective conflicts, such pressures may make the task of checking inflation so great that ordinary fiscal and monetary measures cannot cope with it. In such a situation the government is likely to adopt price and wage controls and general rationing of goods in an attempt to mitigate the problems and inequities of inflation.

Even in a period of mild inflationary pressures, the wage-price guideposts, which originally were little more than a statement of a general relationship between productivity, wages and prices, developed into a form of quasi-controls applied unevenly to different industries. The inflationary pressures of 1966 appear to have largely destroyed the 3.2 percent annual productivity guidepost propounded in 1962 by the Council of Economic Advisers. Several major collective bargaining agreements substantially exceeding the 3.2 percent were negotiated and accepted in 1966.

In a period of rapid price increases the burdens of inflation become very evident. Those whose incomes are fixed in dollar terms suffer reductions in real income, while those who are able to tie their incomes to the price level or to profit by appropriate investments may be net gainers. Long-term financial planning is disrupted when the real value of fixed dollar contracts (debts, pensions, insurance, etc.) can be expected to change by unknown amounts. In periods of more gradual price increases, it is difficult to pinpoint the actual burdens and the extent of income redistribution

that result from inflation. The continued upward trend of the price level since World War II has undoubtedly contributed to the demands for the expansion and liberalization of social security. It has affected the willingness of the public to invest in the stock market. Until the depreciation reforms of 1962, inflation had placed a substantial burden on business because of the inadequacies of depreciation allowances to meet replacement costs of plant and equipment. Moreover, inflation may sow the seeds of a subsequent decline in economic activity. If wage rates continue to rise more rapidly than productivity, the only way to halt inflation may be through policy measures that result in unemployment.

The costs and dangers of inflation, though difficult to measure, must be compared with the costs of unemployment and other unused productive capacity. Under Mr. Heller, the Council of Economic Advisers popularized the term "full-employment gap," which was defined as the difference between actual gross national product and what GNP would have been with fully employed resources. In the Council's *Economic Report* for 1962, this gap was estimated, perhaps generously, at \$40 billion (page 50). Even if this estimate were an exaggerated one, the real cost of unemployed resources merely in economic terms can be very large. Consequently, the "pay-off" for a successful fiscal policy can also be large in terms of additional national output, provided it is not obtained at the cost of distortions in the economy such as may accompany inflation and its possible aftermath in recession.

Another phase of the problem of unemployment versus inflation is the question of how to maintain a high level of employment once it is achieved. Must

what goes up, necessarily come down later? Strong inflationary or deflationary pressures at least give clear indications of the directions in which policy should aim. Balancing the economy at a high level of production and growth without inflation will be a large, but more difficult, assignment. It will require more experience with sources of instability and bottlenecks that arise in both the public and the private sectors, and with various kinds of policies designed to maintain stable growth.

International versus Domestic Goals. One of the goals of economic policy must be the maintenance of "equilibrium" in the balance of international payments. Such an equilibrium may be said to exist if no large flows of gold are occurring into or out of the country, and if no large build-up of short-term liabilities to foreigners is taking place.³ Either or both of these phenomena would be an indication of "disequilibrium" in the balance of payments. Continued disequilibrium in the balance of payments usually forces a country to take measures that interfere with the flow of international trade and investment and that tend to hamper economic growth.

Disequilibrium in the balance of payments is sometimes the result of a country's failure to maintain domestic economic stability. Inflation may result (under a system of fixed exchange rates) in a country "pricing itself out of world markets," so that its exports fall off, while its imports tend to increase. As a result, gold tends to flow out or liabilities to foreigners increase. A country may then find itself faced with the choices of devaluing its currency, taking strong deflationary measures or resorting to extensive direct controls over foreign trade

and finance. A similar situation may develop if a country fails to keep pace with growing productivity in other major countries.

The United States balance of payments problem which appeared in the late 1950's was due to a variety of causes, including rapid economic growth in Western Europe, heavy foreign expenditures by the U. S. for military and economic aid, a large flow of private investment to other countries, and growing U. S. tourist expenditures abroad.

The outflow of gold and the build-up of liabilities to foreigners in the early 1960's led to a series of selective measures which were designed to avoid the conflict between the goals of stimulating economic growth at home while maintaining international financial stability. A deficit in the balance of payments normally calls for deflationary domestic measures. The U. S. Government through the so-called interest-equalization tax, "voluntary" restrictions on private investment abroad, and other measures, tried to correct the imbalance in payments with other countries while still pursuing the goal of stimulating economic growth at home. Since these objectives are not entirely compatible, we have here another set of issues or choices to make in the "trade-off" among policy goals.

Alternative Means to the Given Goals

The events of 1966 dramatically illustrated the choice of emphasis on fiscal versus monetary policy to contain inflation. The course of events and debate showed some of the advantages and disadvantages of each. (For general definitions of fiscal and monetary policy, see page 5, above.)

3. Such short-term liabilities can be quickly turned into gold outflow.

The question of relative emphasis on fiscal or monetary policy must rest on the premise that unless both forms of policy are working in the same direction, strong inflationary or deflationary pressures cannot be contained. The disastrous results of monetary and fiscal policy working in opposite directions have been illustrated more than once in recent history. One example was mentioned in Chapter 2. This was the insistence of the Treasury Department on maintaining low interest rates in the first five years following World War II. This policy committed the Federal Reserve to purchase government securities at artificially high prices, and left the initiative in creation of additional monetary reserves to the commercial banks. They were free, without penalty, to obtain additional lending capacity by selling government securities. Net purchases of securities by the Federal Reserve Banks add an equal amount to the reserves (i.e., deposits) held by commercial banks at Federal Reserve banks, and so make possible further expansion of bank credit. Thus the pegging of interest rates forced an easy money policy despite inflationary pressures in the economy. As a result, fiscal measures — the large cash surpluses of fiscal 1947 and 1948 — could hardly be expected to prevent inflation.

However, when monetary and fiscal policy are leaning in the same direction, and inflationary or deflationary pressures are not extreme, a choice of measures, or of the extent of use of different measures, is possible. This was the situation in late 1965 and 1966. There was a choice of general income tax increases, selective tax increases (such as the postponed tax reductions on automo-

biles and telephone services), other selective measures such as "voluntary" restraints on business capital outlays, government expenditure reductions, and greater reliance on restrictive monetary policy. Similar choices will no doubt have to be made again for 1967.

Fiscal Policies. General changes in tax rates and government expenditure levels, can have a powerful effect on the economy. Moreover, their effects are measurable, at least in rough orders of magnitude. For example, under the Revenue Act of 1964, individual income tax rates were reduced approximately 13 percent for the calendar year 1964 and another 7 percent for calendar 1965. The Act was calculated to reduce individual income tax payments (liabilities) by \$6.3 billion in 1964 and an additional \$3.2 billion in 1965. Economists have estimated that the "multiplier" for changes in government revenues or expenditures is approximately two. That is to say, a tax reduction of \$10 billion, other things being equal,⁴ would result in a total increase in gross national product of \$20 billion. Conversely, a tax increase would be expected to produce an effect on GNP (other things being equal) of about twice its size.

There is a question of how much of a lag is involved between the time of a tax cut and its full effects on the economy. According to estimates of the Council of Economic Advisers, at least a year is necessary for the major part of the effects to be felt.⁵

The Council's estimate for the Revenue Act of 1964 included a reduction in the corporation income tax as well as in individual income taxes. However, the

4. This caveat included the assumption that monetary policy would also be "easy."

5. In 1962 the CEA staff estimated that about half of the effect of a tax reduction would be felt within one year. (*Hearings before the Joint Economic Committee, Congress of the United States, January 1963 Economic Report of the President, Part 1, p. 20.*)

effects of a change in the corporation tax are more difficult to estimate than in the case of the individual income tax. In 1964 particularly, the effects of the corporation tax reduction were partially offset by a speed-up of corporate tax payments, so that while tax liabilities per dollar of profits were reduced, the actual flow of cash payments to the government was affected very little.

The 1966 action in suspending the corporation investment tax credit and limiting depreciation allowances raises the question of what the effect will be on business investment, and over what period that effect will take place. Will it be more effective than a general increase in the corporation income tax involving the same amount of revenue? Will a further increase in individual income taxes be required to check inflation? Unfortunately, the many forces affecting business investment (such as cost and availability of capital funds, consumer buying, prospective profits, etc.) are difficult to untangle.

When the investment tax credit was passed (in 1962) it was combined with changes in tax depreciation policy. The Treasury estimated that together these changes would reduce corporate tax liabilities by about \$2 billion. Since they were tied directly to capital outlays, they presumably had a greater effect on investment than an equivalent general reduction in the corporation tax which would have gone in part toward increasing dividends. Conversely, their suspension will probably have a greater effect on business investment than would an increase of equal amount in the corporation income tax.

The question of the lag involved is clearly more important than in the case

of the individual income tax. Individuals can quickly change their spending plans, whereas corporations and other businesses generally have a more formalized budgeting and planning process. Once business investment plans are set, they are more difficult to change than household plans. However, investment plans do get revised, as shown by the successive surveys of business capital spending plans by the Department of Commerce and the McGraw-Hill Company. The investment tax credit suspension presumably came at a time (early fall) when plans for the coming year were being formalized by corporations. Its effects may be greater, therefore, than if the change were made, say, just after the beginning of the year.⁶

The lag in effects of tax changes may mean perverse results. Tax increases, through their effects on the cost side, may contribute to "cost-push" inflation, after excess total demand has been removed.⁷ The perverse effect of lags may be important in the second half of 1967, when the scheduled reinstatement of the investment tax credit at the beginning of 1968 could have a powerful effect in delaying business capital outlays.

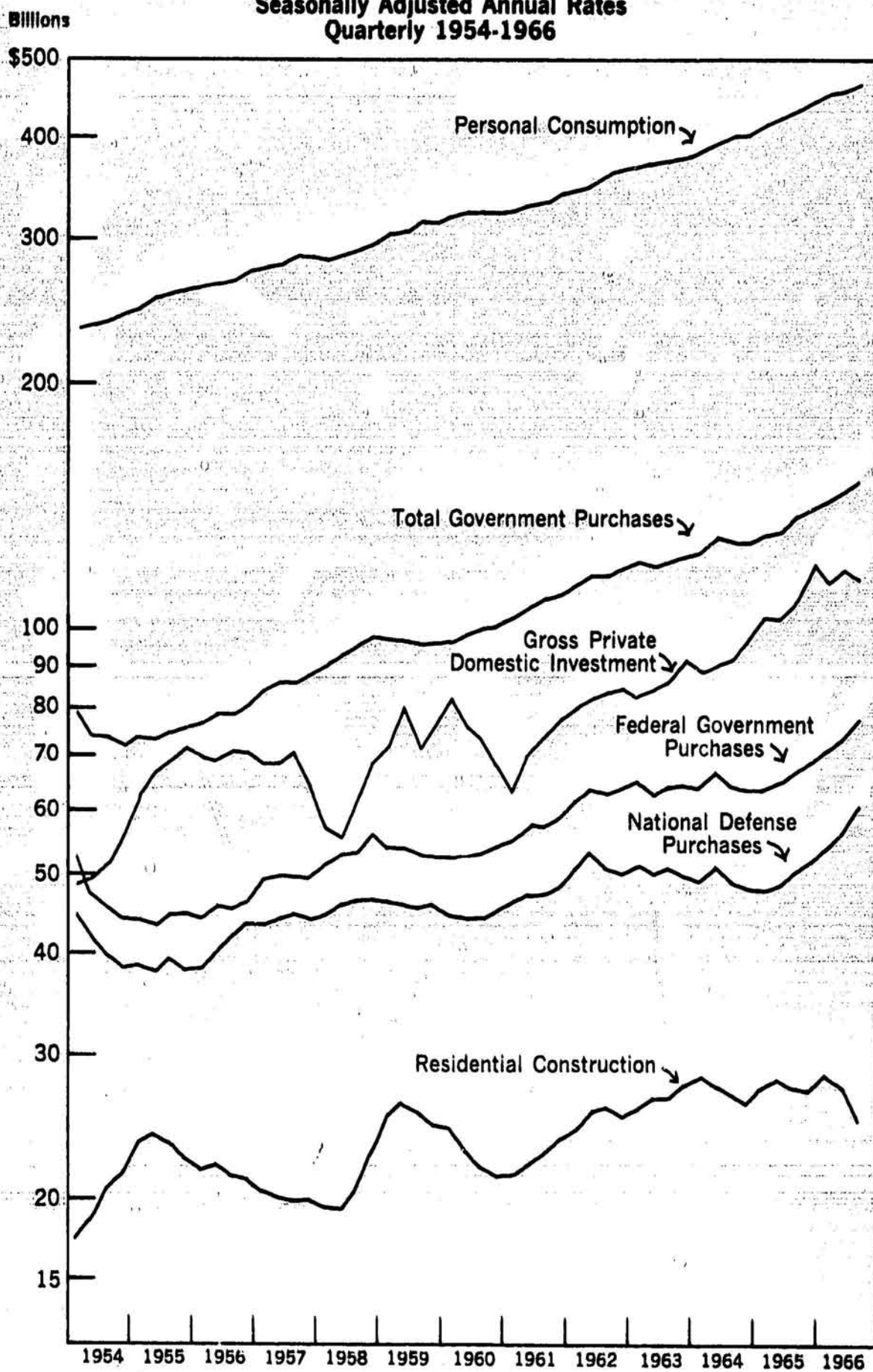
Whether or not a general tax increase will be required in the future will depend upon the extent to which total demand may be expected to grow in 1967 taking account of the restrictive measures already in force, and the extent to which the growth of government expenditures other than defense can be curtailed. Estimates of the extent of further increases in defense expenditures and of the prospective increase in private expenditures will be crucial in this decision. (See Chart 8 for recent trends.)

The build-up of Defense Department

6. Most corporations operate on a calendar year basis.

7. See Robert C. Tyson, "A Look at Fiscal Policy," *Tax Review*, Vol. 27, No. 6, pp. 21-24.

Chart 8
SELECTED COMPONENTS OF GROSS NATIONAL PRODUCT
 Seasonally Adjusted Annual Rates
 Quarterly 1954-1966



Source: U.S. Department of Commerce, Office of Business Economics.

obligations has yet (up to the end of 1966) to show any sign of levelling off. The Lionel D. Edie survey of corporate investment plans for 1967 (released in October) showed a prospective levelling off in this sector of production.⁸ The U. S. Department of Commerce and McGraw-Hill Company surveys of business capital expenditure plans for 1967, published in November and December, showed a prospective increase of only 5 to 8 percent in business capital outlays in 1967, as compared with an increase of 17 percent in 1966. The outlook for defense expenditures in 1967 appears to be for another substantial increase.

One obstacle to further tax measures is the fact that barriers to quick and timely action have not been significantly reduced. In the spring of 1966 the Subcommittee on Fiscal Policy of the Joint Economic Committee held hearings dealing in part with possible forms of stand-by tax legislation for anti-inflationary or anti-recession purposes. Proposals were examined for general increases in income tax rates, the form of which could be agreed on in advance. The only action required, in the case of strong inflationary or deflationary pressures, would then be to determine the size and effective date of the change. Presumably the lengthy delays involved in committee and Congressional debate over the *kind* of change to be made would be avoided. However, the debate over the kind of tax change to be made was not carried, in 1966, to the point of agreement. In fact the hearings disclosed

rather wide divergences of views on exactly what kind of "general" tax change would be appropriate.⁹ As a result, further tax action, if required in 1967, must go through the process of debate over the kind of change to be made as well as its timing and extent.

Monetary Policies. The impact of restrictive monetary policy falls initially on investment expenditures — on those who must borrow to make capital outlays.¹⁰ This impact is far from being evenly distributed. In the normal workings of financial markets, it is appropriate that tight money — through changes in cost or availability of funds — initially restrict marginal borrowers: those whose credit standing is not high and whose projects may show relatively low rates of return. However, in the last two decades it has been demonstrated that a large part of the impact of tight money falls on residential construction because of the tendency of funds to be diverted from home mortgages. This is partly because of the relative stability of interest rates on mortgages as compared with other interest rates. In portions of the market, in fact, interest rate ceilings are fixed by law. When other interest rates rise, funds tend to flow from the mortgage market to other uses where lenders get better returns on their money.

With the record high levels of interest rates that have occurred recently, flows of funds away from mortgages to other investments have led to a decline in housing starts. For large investors, the government bond market, with possibil-

8. *New York Times*, October 10, 1966, p. 63.

9. Among the possibilities considered were a surtax of 5 percent on existing individual and corporate tax liabilities, a 5 percent increase in tax rates throughout the income scale as well as for corporations, and a given percentage point change in existing tax rates.

10. A "restrictive monetary policy" may be defined in terms of various indicators. It is usually reflected in an increase in the cost of borrowed funds (interest rates) and more limited availability of funds (reflected in other terms and conditions of loans, as well as in interest rates). Some would define monetary policy, not in terms of immediate credit conditions, but by the relation between changes in the money supply and actual or potential changes in output. Because of the lag in the effects of changes in the quantity of money, it is argued, monetary policy should be formulated from a longer-term point of view than results from a day-to-day analysis of economic and money market conditions.

ities of substantial capital gains,¹¹ has proved very attractive. In addition, Federal government sales of "participation notes" (until their suspension in September 1966) added to the pressures on financial markets by absorbing funds that otherwise would have been available for private purposes.¹²

Putting the major emphasis on restrictive monetary policy thus concentrates the burdens of checking inflation on particular groups of borrowers and those indirectly dependent on such financing. The suspension of the investment credit and the limitations on accelerated depreciation will probably spread the needed restriction of demand more evenly on business plant and equipment expenditures. However, the fiscal and monetary actions of 1966 did little to check consumption spending. A general increase in the individual income tax, on the other hand, would fall primarily on consumption. Since we are financing a war effort, a reduction in consumption would seem to be in order.

Controlling Government Expenditures. Consumption could be reduced not only by increasing individual income taxes, but also by cutting back on many government programs which serve to increase consumption.

As President Johnson emphasized in his message to Congress on the suspension of the investment tax credit, a large cut-back in government expenditures is difficult to achieve because so much of the budget is for defense or is legally

committed at least for a year ahead. Tax Foundation has shown that even in a year in which defense needs were not exceptionally large only about one-third of Federal expenditures is subject to *annual* control through the appropriations process.¹³

In addition to the large amounts of expenditures, particularly interest on the debt, to which the government is committed by law, there is a large amount of "open-end" expenditure which can be significantly affected only by substantive legislation on programs. Thus much of the expenditure on veterans' benefits is governed by conditions of eligibility set out in the law and by the number of veterans claiming benefits. Such expenditures can hardly be modified to meet the needs of an inflationary situation that may last for less than a year (although GI insurance refunds have been timed in the past as a supplementary anti-recession measure).

Thus a large percentage change in "low priority" programs is necessary to produce a sizable cut — say \$3 or \$4 billion — in expenditures. Moreover, the question of just what are "low priority" programs is difficult for the average citizen, as well as for Congressmen, to determine. Most expenditure programs have strong and vociferous proponents among their beneficiaries and other groups.

In the case of both expenditures and taxes, the lags between proposals, legislative enactments, and effects, are prob-

11. Rising interest rates reduce market prices of outstanding government bonds—their yields (interest/market price) are forced up by the competition of other investment outlets. When interest rates appear to have reached their peak, sharp investors may buy bonds in the expectation that a subsequent reduction in interest rates will raise bond prices. Thus a capital gain can be made on bonds during a period of falling interest rates. For example, a \$1,000 long-term bond with a stated interest rate of 3 percent (and thus paying \$30 a year in interest) would tend to sell in the bond market at a price making the yield approximately equal to yields in the market on similar securities. If market yields on such securities rose to, say, 4 percent, the price of a 3 percent bond would tend to fall to \$750. At such a price, people who correctly forecast a fall in yields, and purchased such bonds, would make a capital gain.

12. Tax Foundation, *Expanded Federal Asset Disposals Emphasized in 1967 Budget*. Special Report 1966-2 (Washington, D.C., 1966).

13. Tax Foundation, *Controlling Federal Expenditures*, Project Note No. 51 (New York: 1963). Also *Congressional Control of Federal Expenditures*, Government Finance Brief No. 1, New Series (New York: 1965).

ably considerably greater than in the case of monetary policy. The Federal Reserve Open Market Committee meets every three weeks, and open market operations are carried on with close current scrutiny of monetary and economic conditions. Even though there are substantial lags in monetary effects, the great advantage of monetary policy is its flexibility to meet changes in needs for stabilization measures.

Measuring the Economic Situation

The difficulties of evaluating the current economic situation and its future course are well illustrated by the events of 1965 and 1966. In retrospect it is clear that the Administration was slow to recognize the extent of inflationary pressures.

Lags in the availability of data have been one of the serious problems in interpreting economic conditions. Thus the National Bureau of Economic Research cannot normally designate a "turning point" (peak or trough in business activity) until about six months after that point has been reached.¹⁴

For policy planning purposes, however, the more important time span lies in the other direction, namely that policy must be planned for some period in the future. Consequently, assumptions or forecasts about economic conditions are a prerequisite to policy decisions. In addition, most kinds of fiscal and monetary actions to implement policy have lags in their effects on the economy. Consequently, we are often driving in a dim light with which to see the conditions under which policy actions will take effect.

For example, for policy planning and budgeting purposes at the end of calendar 1965, the Council of Economic Advisers projected GNP for calendar 1966 at \$722 billion. In December 1966, preliminary estimates put 1966 GNP at close to \$740 billion. This was one of the largest official forecasting errors in recent years.

The Federal Government's forecasts or assumptions for GNP on which budget estimates are based have usually been good. This is indicated by Table 6 which shows that the percentage error in the GNP forecasts for the calendar year as compared with the actual figures averaged 1.7 percent in the 11 year period 1955 to 1965, and the largest errors were 3.8 percent and 3.6 percent for 1955 and 1956 respectively. For the years 1957-1965 the error averaged only 1.2 percent and exceeded 2 percent in only one year (Table 6).

This record in GNP forecasting is good in comparison with general business forecasts using the simple criterion of differences between estimates and actuals.¹⁵ However, small percentages of large absolute figures can be misleading because they do not immediately suggest or indicate the large absolute amounts that may be involved. For example, a 2 percent error in forecasting GNP when GNP is at a level of \$722 billion (the estimate used for calendar 1966 in the *U. S. Budget* for 1967) amounts to \$14.4 billion. This is a large sum in relation to the size of the possible effects of tax changes. A two percent, or \$14 billion error is also large in relation to the annual trend rate of growth in GNP, which is in the neighborhood of 3 percent.

14. The National Bureau of Economic Research, a private organization which has pioneered in studies of business cycles for over 40 years, developed techniques for dating turning points of cycles now widely adopted as reference points in the analysis of business conditions.

15. See Victor Zarnowitz and others, "Study of Short-term Economic Forecasting," in *The Task of Economics*, Forty-Fifth Annual Report, National Bureau of Economic Research (New York: 1965), pp. 59-67.

Table 6
Federal Executive Branch Forecasts of GNP^a
For Budget and Fiscal Policy Purposes
Compared with Actual GNP^b

Calendar Years 1955-1966
(Amounts in Billions)

Year	Forecast or assumed level (a)	Actual (b)	Forecast less actual	
			Amount	Percent of actual
1955	\$375 ^c	\$390	\$ -15	-3.8%
1956	400 ^c	415	-15	-3.6
1957	435	440	- 5	-1.1
1958	445	442	+ 3	+0.7
1959	473	482	- 9	-1.9
1960	510	504	+ 6	+1.2
1961	512	519	- 7	-1.3
1962	570	555	+15	+2.7
1963	578	584	- 6	-1.0
1964	623	623	—	0.0
1965	660	666 ^d	- 6	-0.9
1966	722	739 ^e	-17	-2.3
Average percentage "error" ^f				
1955-1965				1.7
1957-1965				1.2

a. Levels forecast or assumed for purposes of estimating Federal budget receipts and expenditures.

b. First "actuals" appearing July issues on the *Survey of Current Business* of the following calendar year. The "errors" would have been slightly smaller if the forecasts had been compared with first official preliminary figures of GNP for each year published in the February issues of the *Survey of Current Business*.

c. These forecasts assumed a constant level of prices. Subsequent forecasts allowed for some change in prices.

d. Estimated on basis of old GNP series (see source note below).

e. Preliminary unofficial estimate.

f. Simple arithmetic average computed without regard to sign. The average absolute error without adjustment for differences in price levels was \$7.9 billion for the period 1955-1965, and \$6.3 billion for the period 1957-1965.

Source: Forecast or assumed levels of GNP:

1960, 1962-1966: *The Budget of the United States Government* for the following fiscal year (section on budget receipts).

1955-1959, and 1961: *Joint Economic Committee Report on the Economic Report of the President* for each year.

Actuals: *Survey of Current Business*, July issues, except for 1965 which was estimated on the basis of the Department of Commerce series before the 1965 revisions in the national income accounts. The change in the old series in the third and fourth quarters of 1965 was assumed to be proportional to the change in the new GNP series.

Moreover, relatively small errors in GNP forecasts lead to larger percentage errors in estimates of budget receipts and expenditures and in cash budget estimates (see Tables 1 and 5). As a recession develops, receipts tend to be overestimated while in an expansionary

period receipts are usually underestimated.

In short, the apparent smallness of forecasting errors in GNP in the CEA's record for the past decade is somewhat misleading in that they are too crude a criterion of "success." The question may

be raised whether the statistical data available provide reliable grounds for decisions on major tax changes.¹⁶

The development of forecasting techniques has recently gone more in the direction of "econometric models" making use of computers and more elaborate theoretical and statistical methods. This kind of development so far does not appear to have significantly reduced forecasting errors.¹⁷ Its significance lies rather in the ability to simulate the effects of alternative policies and to estimate the orders of magnitude of particu-

lar kinds of tax or other changes. Thus, the quantitative consideration of alternative policies can be considerably improved. For example, what orders of magnitude could be expected in the effects of, say, a \$10 billion tax reduction, or a \$10 billion increase in expenditures, as compared with a \$5 billion increase in the money supply in a given year in which stimulus was desirable? The use of simulation techniques is still in the early stages of development, but it suggests substantial possibilities for improved economic policy decisions in the future.¹⁸

POLITICAL ISSUES

Fiscal policy must be developed and implemented within the political framework which exists at the time. No purely economic formulation of policy can be made without consideration of other goals, programs, and interests. The Employment Act of 1946 made clear that the objective of "useful employment opportunities for those able, willing, and seeking to work" was not to be pursued only through selected actions and programs, but rather that the government was "to coordinate and utilize all its plans, functions, and resources" for this purpose "in a manner calculated to foster and promote free competitive enterprise and the general welfare . . ."

In a democracy the desirability of coordinated policies must be balanced by appropriate representation of interest groups and viewpoints in the debate on, and formulation of, policies. There are current dangers and issues in each of these aspects of the political and administrative process in the United States,

namely the need for coordination of policies, and for coordination achieved through democratic processes.

Coordination of Policies

The Employment Act went little further than the injunction to coordinate all the government's resources, etc., for purposes of the Act. The Act did not specify how the activities of the Council of Economic Advisers were to be coordinated with those of the Treasury Department, the Bureau of the Budget, or other agencies of government. Neither did it provide any means beyond the advisory functions of the Joint Economic Committee for coordination of legislative action for fiscal policy purposes.

On the executive side of government, various arrangements for policy coordination have developed. In the legislative branch, focusing on fiscal policy goals is more difficult.

It may be argued that divergent and

16. See Robert C. Tyson, "A Look at Fiscal Policy," *Tax Review*, Vol. 27, No. 6, June 1966, pp. 21-24.

17. The U.S. Department of Commerce, however, has recently released the results of its econometric model, which appears to have reduced forecasting errors. See *Survey of Current Business*, May 1966, p. 13ff.

18. Daniel Suits, "Forecasting With An Econometric Model," *American Economic Review*, Vol. 52, No. 1, March 1962, pp. 104-132.

inconsistent goals are a major obstacle to an effective fiscal policy. Proposals have been made for greater focusing of responsibility for over-all policy in both the Executive Branch and in Congress.

The Executive Side. The Executive Branch, as the administrative arm of government, is intended to emphasize coordination and centralized responsibility. However, in the United States particularly, the executive agencies and departments have become active participants in the political process. The Department of Agriculture, for example, in part represents the interests of farmers, both in the formation of Executive policies and in supporting proposed legislation before Congressional committees. The Treasury Department has tended to represent fiscal orthodoxy, even though that orthodoxy has changed over time. The Bureau of the Budget traditionally represents an economy point of view on expenditures as opposed to the program orientation of other administrative agencies. Similarly, the Council of Economic Advisers has emerged "as the symbol of the President's responsibility for the nation's economic welfare and as . . . the government's economic ideologist."¹⁹

The Employment Act directed the Council "to study means of coordinating programs in order to further the policy of this Act . . ." In practice a variety of procedures have been used for coordination of policies. The effectiveness of these procedures becomes an important issue when a serious divergence of views develops such as the question in late 1965 of the timing of Federal Reserve action in raising the discount rate.

In the ordinary course of events, the work of interagency staff committees

and meetings of members of the CEA, the Federal Reserve Board, the Treasury Department, and the Bureau of the Budget provide a continuing basis for coordination. In 1954 an Advisory Board of Economic Growth and Stability was established under the Chairman of the Council of Economic Advisers. On this Board the following departments and agencies were represented: Treasury, Agriculture, Commerce, Labor, Federal Reserve, Budget Bureau, and the White House. The Board usually met weekly but served chiefly as a means of exchanging information. According to Mr. Gabriel Hauge (then White House Economics Adviser), "probably its greatest contribution was in giving the agency people some sense of the over-all economic effects of their actions — greater perspective, great integration."²⁰

This Board, however, became less active as time went on. A similar arrangement was instituted in 1961. It was a committee, consisting initially of the Chairman of the Council of Economic Advisers, the Secretary of the Treasury, and the Director of the Bureau of the Budget. It later included the Chairman of the Board of Governors of the Federal Reserve System. The committee was backed up by staff work on the part of interagency staff committees and task forces. This kind of informal coordination has continued to grow. The expanding activities of the CEA in cooperating with other agencies are described annually in an Appendix to the Council's *Economic Report*.

Coordination is promoted by such interagency cooperation and by debate over issues that leads to a consensus on the roles of different agencies and the policy "mix" to be used in the pursuit of

19. Edward S. Flash, Jr., *Economic Advice and Presidential Leadership: The Council of Economic Advisers*, (New York: Columbia University Press, 1965), p. 276.

20. Quoted by Edward S. Flash, Jr., *op. cit.*, p. 170.

major economic objectives. In the event of disagreement, the President can become the arbiter and final coordinator.

In this process the Chairman of the Federal Reserve Board occupies a special position in that he is not a member of the Executive Branch but the head of an "independent agency" responsible to Congress. The Federal Reserve Board is thus formally "independent" of the Administration and can make its own policies. The confrontation in the fall of 1965 over raising the discount rate dramatized the issue of Federal Reserve independence, although this issue had been debated and investigated in depth over a good many years.

Critics of the Federal Reserve's independent status stressed the anachronisms in the Federal Reserve structure reflecting economic conditions and political pressures of earlier periods.²¹ The criticism is often made that the Federal Reserve Board, which does not have to seek appropriations from Congress, and whose members are not removable on policy grounds, is essentially not controllable either by Congress or the President.

In 1964 a subcommittee of the House Committee on Banking and Currency held extensive hearings dealing in part with the question of the independence of the Federal Reserve System. The unanimous testimony of Administration and Federal Reserve officials at the time was that the informal controls that have developed in fact work well and that changes in the present status of the System might do more harm than good. Mr. Martin testified that the Board and the Open Market Committee are in fact sen-

sitive to the policy positions and problems facing the Administration.²²

While officials in the Executive Branch supported this view, there was substantial testimony to the effect that the Federal Reserve System should be formally responsible to the Administration in basic policy decisions. Moreover, after the Federal Reserve raised the discount rate in December 1965, the Joint Economic Committee held hearings on the System's action, and the majority expressed the following views in its Economic Report for 1966:

In spite of the clear mandate in the Employment Act that all 'plans, functions, and resources' be coordinated in the interest of the Employment's objectives, the Board of Governors of the Federal Reserve, by a 4-to-3 vote, saw fit to raise the discount rate right after the administration had made it very clear that such an increase was not warranted at that time.

In the committee's view, lack of coordination in the use of the Government's principal stabilization tools is untenable in a modern dynamic society. There should be legislation to bar any repetition (pp. 6, 7).

The events of 1966 provided evidence for both sides on this issue. In the view of some, the independence of the Federal Reserve provided needed flexibility for restrictive measures at a time when the Administration was slow to take action and presumably underestimated the extent of inflationary pressures.

Over the past decade, however, as illustrated by the review in Chapter II, there is evidence of increasing coordination of fiscal and monetary policy. Particularly, in the last five years with the emphasis on the goal of increasing economic growth, a continued easy money

21. For example, Michael D. Reagan, "The Political Structure of the Federal Reserve System," *American Political Science Review*, March 1961, Vol. 55, No. 1, pp. 64-76.

22. *The Federal Reserve System After Fifty Years*, Hearings before the Subcommittee on Domestic Finance of the Committee on Banking and Currency, House of Representatives, 82d Congress, 2d Sess., Vol. 1, p. 9.

policy has played an important part in supporting a stimulative fiscal policy. Indeed, some economists would give as much or more credit for our "longest expansion" to monetary as to fiscal policy.²³

The Legislative Side. While the powers of the Presidency have expanded in recent years, the United States government constitutionally remains a system in which several major focuses of power are intended to provide a check on the possible excesses of any one branch of government. This multiplicity of sources of power and initiative is also characteristic of the Executive Branch and of the so-called "independent agencies." Each agency, and even divisions or bureaus within major departments, may carry some special weight at times with Congress and frustrate policies of the White House. Congress itself is loosely organized as compared with the much stricter party discipline under the parliamentary system.

The significance of this fact of life in fiscal affairs lies not so much on the tax side as on the expenditure side, in the authorization of programs and the appropriation of funds. Appropriation bills are examined in piecemeal fashion, with no Congressional procedures in the appropriations process for the consideration of the over-all impact of expenditure actions and the relation of expenditures to tax measures. Various proposals over the past two decades for improving the budgetary actions of Congress have brought little change. Even the latest study by the Committee on the Organization of Congress has resulted in little variation in proposed changes or in the

likelihood of their adoption.²⁴

The creation of the Joint Economic Committee by the Employment Act of 1946 was an attempt to focus Congressional attention on the over-all economic impact of Federal operations, but the Act gave the Joint Committee only an advisory role. The Joint Committee in fact has effectively exploited this role in providing a Congressional forum in its hearings for debate of fiscal policies, a testing ground for the Administration to support and defend its policies, and an opportunity for the public and non-governmental agencies to express their views.

The Committee has widened its influence further by its annual reports, the special studies it has commissioned and published. According to one assessment, the Committee's influence on policy has been substantial:

Not only have the Committee's studies affected a broad range of legislation but their direct influence, both current and long range, on the actions of executive agencies has been impressive. Today's concerns (February 1966) over restoring excise tax cuts and increasing tax rates remind us of the Joint Economic Committee's unanimous resolution in July 1950 calling for an immediate increase in taxes to finance the Korean war . . . There was the Treasury-Federal Reserve 'accord' which came out of the Subcommittee on Monetary Policy's studies, and the new or improved statistics initiated as a result of the studies of the subcommittee working so intensively in that area. Studies of balance of payments and foreign economics bore fruit in the Trade Expansion Act and some of the corrective measures involving the balance of payments . . .²⁵

23. See Allan H. Meltzer, "The Money Managers and the Boom," *Challenge*, March-April, 1966 pp. 5-7.

24. To date no action has been taken on recommendations of the Committee. See *Organization of Congress*, Final Report of the Joint Committee on the Organization of the Congress, Senate Report No. 1414, 89 Cong., 2d sess., July 28, 1966.

25. John W. Lehman in *Twentieth Anniversary of the Employment Act of 1946, An Economic Symposium*, Joint Economic Committee, Congress of the United States, 89th Cong., 2d sess., February 1966, p. 88.

It appears, however, that the Joint Economic Committee's efforts have been more influential on the tax side than on the expenditure side of Congressional fiscal action. The Joint Committee's major activities usually come early in each session of Congress in reviewing and holding hearings on the *Economic Report of the President*. It makes no corresponding review of Congressional action on appropriations.

Representation of Different Viewpoints in Policy Formation

It is sometimes argued that the role of the Council of Economic Advisers suggests the danger of an excessive degree of influence being exercised by a group of professionals not sufficiently subject to democratic controls. There is a question of whether adequate opportunity exists for differing points of view to be brought into the debate on economic policy.

The nature of the controls and balances that exist in the policymaking process is difficult to assess. The Council of Economic Advisers is certainly "expendable" as illustrated by its temporary demise during the first year of the Eisenhower Administration. The danger of narrow or one-sided points of view gaining undue influence is mitigated by the fact that the process of developing "policy positions" within the Executive Branch involves a process of debate similar to that in legislative bodies. The representation of different interests and viewpoints within the Executive Branch is narrower than in the Legislative Branch, but at least the internal debate on issues provides some degree of balance and control.

On the legislative side, the criticism

has been made that despite the Joint Economic Committee's activities in its hearings, studies, and publications, Congress does not have the facilities for adequate consideration and debate of fiscal policies. Representative Thomas B. Curtis recently proposed the establishment of:

... a new, additional, advisory, research and information organization ... under the Employment Act to enable minority party representatives in Congress better to analyze and present minority alternatives to our administration economic policy decisions. This "minority" economic council would be responsible to whichever party does not control the White House, and would be funded by Congress. ...

... debate on economic issues is today not extensive enough or thorough enough. It needs further development; principally, it needs a better informed, institutionalized challenger able to create more intelligent public discussion even of the most technical issues. Through such improved debate, economic policy issues would be refined and clarified.

...

... The minority in Congress must have the research resources necessary to suggest workable alternatives to Government policy in all important economic areas. I believe there is considerable dissent in our society, within its broader consensus. Our problem is how to channel that dissent — to create a way to bring informed dissenters together to devise and propose creative alternatives based on their expert knowledge.²⁶

The implications of this proposal involve problems of reorganization and realignments of responsibilities in Congress — problems which were not really pursued in depth by the recent committee on reorganization of Congress (see above page 44).

26. *Ibid.*, p. 124.

It is noteworthy, however, that while Congressional facilities for consideration of fiscal policy may be limited, a growing number of private groups are becoming sources of debate and informed opinion on fiscal measures. The most evident of these groups are the associations of business and labor, the many professional groups, and the privately supported research organizations with an interest in fiscal policy, monetary policy, tax policy, or various expenditure programs.

Some of these organizations do work closely paralleling that of the Council of Economic Advisers. They analyze the economic situation, examine policy alternatives, testify on policy issues. The op-

portunity for work on fiscal policy from points of view different from those of the Administration is certainly available.

The work of such groups provides countervailing influences on public opinion and checks on governmental policies and actions. They also often supply important initiatives for government action that otherwise might not be forthcoming. Since World War II the importance of private groups, outside of party politics, playing a role in policy oriented research and in influencing public opinion, has become a significant element in national politics. This is true not only in the case of fiscal policy problems, but also in many other technical and scientific areas.

IV.

Concluding Observations: Role of Government in the Economy

The increasing emphasis on fiscal policy for stability and growth was described in Chapter II. While many important issues continue to be debated, a general agreement seems to have emerged covering at least two points: (1) that "money will not manage itself," and (2) that fiscal and monetary policies can be devised that will improve the performance of the economy in the aggregate over what would take place in the absence of policies designed to affect the over-all levels of economic activity. These two points represent relatively new responsibilities for government.

The Employment Act of 1946, indeed, explicitly enunciated new responsibilities for the Federal government in maintaining employment and stimulating national output within the framework of a free enterprise economy.

The consensus on these new responsibilities, however, begins to break down when applied in particular situations.

One important development is a tendency to move from more aggregative policies and actions to more detailed measures on both the tax and expenditure sides. This tendency raises issues of the extension of the role of the Federal government. Is the Federal government to be limited to providing the basic rules and conditions necessary for the functioning of a free enterprise economy, or is it to move further and further into par-

ticular segments and activities of the economy?

The issues here revolve in part on changing views on what is needed for the most effective functioning of a free enterprise economy. What are the particular kinds of activities in which private enterprise may not function well? Is there a possibility of more effective functioning under some governmental policy or program?

The very limitations of aggregative policies in achieving the goals of the Employment Act have tended to push successive administrations toward more concern with, and more reliance on, "selective" measures (e.g. changes in the investment tax credit and depreciation policy).

Recent evaluations of the wage-price guideposts, for example, range all the way from the judgment that they have been of some constructive value in checking inflation to the view that they have been injurious in that they interfere with the "normal" working of market forces. Similarly, the "voluntary" restraints on investment abroad and on domestic investment involve inequities and interference with market forces similar to those of direct control programs. To justify direct controls, one must show not only that aggregative stabilization measures cannot be ade-

quate, but also that the particular controls will do more good than harm.

The past decade provides examples of aggregative fiscal policy measures (as well as monetary measures) that were either too tight or too stimulative, or that came at the wrong times. The inability to develop general fiscal policy measures with sufficient speed and sufficient adaptability to the size of stabilization needs is one of the influences that leads to greater reliance on selective measures and exhortations to private groups that often amount to threats of punitive action.

The issues here reach beyond the questions of the general responsibility

of the government for maximum production, employment, and purchasing power, to questions of the extent of interference with free markets and free individual choice. The difficulty of pursuing all of the goals of the Employment Act with reasonable balance was noted above. The extent to which specific controls and programs are selectively used to achieve economic objectives (such as full employment, rapid economic growth, and income redistribution), raises the issue of how compatible these measures are with the objective stated in the Employment Act of keeping government actions consistent with the effective working of a free enterprise economy.

Appendix I

EXCERPTS ON FISCAL POLICY FROM THE PRESIDENT'S BUDGET MESSAGES 1955-1966

Page

Budget Message for the Fiscal Year 1956 (January 1955)

M5 The fiscal and budget story during this past year centers around the fact that we successfully made the adjustment from a wartime to a peacetime type of economy, a truly significant achievement. Aided by a proper fiscal policy, the inevitable dislocations of this adjustment, . . . have not been serious on the whole. Our present growing prosperity has solid foundations, free from the artificial stimulations of war or inflation . . .

The 1956 budget is based on this outlook. Total expenditures will be reduced. However, I am recommending somewhat increased expenditures in particular areas important to human well-being . . .

. . . Our economy is strong and prosperous but we should not dissipate our economic strength through inflationary deficits. I have therefore recommended to the Congress extension [of the Korean War] tax rates . . . If this is done, and employment and production increase as currently anticipated, we can expect budget receipts to rise \$1 billion dollars over 1955 . . .

On the basis of these estimates . . . the deficit will be reduced from the presently estimated \$4.5 billion dollars . . . in . . . 1955 to an estimated \$2.4 billion dollars in 1956. Thus we continue to progress toward a balanced budget.

M6 Three broad considerations of national policy have guided me in framing the budget for the fiscal year 1956.

First, we must defend our priceless heritage of political liberty and personal freedom against attack . . .

Second, the Government must do its part to advance human welfare and encourage economic growth with constructive actions, but only where our people cannot take the necessary actions for

Page

themselves. As far as possible, these steps should be taken in partnership with State and local government and private enterprise. We must do our part to provide the environment for our free enterprise system to keep employment high, to create new jobs, and to raise the standard of living . . .

Third, we must maintain financial strength. Preserving the value of the dollar is a matter of vital concern to each of us. . . . This administration has made a stable dollar and economy in Government operations positive policies from the top down. Expenditure reductions, together with a judicious tax program, effective monetary policy, and careful management of the public debt, will help to assure a stable cost-of-living — continuing our achievement of the past 2 years.

A liberal attitude toward the welfare of people and a conservative approach to the use of their money have shaped this budget. Our determination to keep working toward a balanced budget provides the discipline essential for wise and efficient management of the public business.

Budget Message for the Fiscal Year 1957 (January 1956)

M5 The budget I am proposing for 1957 is a balanced budget. It is my expectation that the budget will also be in balance for the fiscal year 1956.

The present encouraging budgetary outlook arises from a favorable combination of factors involving both receipts and expenditures. . . . In the achievement of this prosperity, the historic . . . tax reduction and reform program of 1954 . . . and the confidence born of prudent fiscal and credit management have been strong energizing factors.

M6 [The increase in expenditures] . . . will be more than offset by the rise in receipts

estimated to result from continued growth in the national economy.

...

- M7 . . . While continuing substantial expenditures for military defense and mutual security, with some increases where needed, we can now propose the expansion of certain domestic programs, and, at the same time, strengthen our financial position by a balanced budget. But we must make sure that we do not undermine our financial strength by laying the groundwork for future budget deficits.

A budget is not just a book of figures describing fiscal operations — it is a comprehensive plan of action for meeting our national objectives. As such, it affects every phase of life and activity of the Nation. It is necessarily complex. Like the plans for a building, the budget must be sketched from various points of view to give a clear idea of its content and composition.

Budget Message for the Fiscal Year 1958 (January 1957)

- M5 This is the fourth budget which I have transmitted to the Congress.

In my first budget message—that for the fiscal year 1955 — I emphasized the administration's determination to chart a course toward two important fiscal goals — balanced budgets and tax reductions.

Reduction in spending evidenced in the 1955 budget made possible a large tax reduction and tax reform program.

The 1956 budget was balanced.

The 1957 budget was balanced.

A balanced budget is proposed for 1958.

I believe this policy of fiscal integrity has contributed significantly to the soundness of our Nation's economic growth and that it will continue to do so during the coming fiscal year.

. . . In making plans for the coming year, I have been guided by the following national objectives:

...

3. A healthy and growing economy with prosperity widely shared;

...

6. Fiscal integrity;

...

8. Increasing international trade and investment essential to the growth of economies of the United States and the rest of the free world.

...

- M6 Today, almost 12 years after World War II, the United States has demonstrated that it is possible to sustain a high employment economy independent of war and continually unbalanced Federal budgets. Adjustments to changing economic circumstances have been and are being made successfully. Productivity and living conditions have improved. With solid public and private policies, the prospect for continued economic growth is bright.

Attainment of that goal is possible only with prudent management of the Government's fiscal affairs. Our Federal budget must contribute to the Nation's financial stability and to the preservation of the purchasing power of the dollar. Maintaining a sound dollar requires of us both self-discipline and courage. At a time like the present when the economy is operating at a very high rate and is subject to inflationary pressures, Government clearly should seek to alleviate rather than aggravate those pressures . . .

For the Government to do its part in the coming year, taxes must be retained at the present rates so that receipts will exceed budget expenditures and the public debt can be further reduced. The prospective budget surplus in the fiscal year 1958 will reinforce the restraining effect of present credit and monetary policies. The present situation also requires that less pressing expenditure programs must be held back and some meritorious proposals postponed.

...

- M6 . . . in view of the present active competition for labor, materials, and equipment, I am not recommending some other desirable construction projects, and I have asked the head of each Federal agency to watch closely the timing of construction and to postpone work which can be appropriately put off until a later date.

- M8 It is my firm belief that tax rates are still too high and that we should look forward to further tax reductions as soon