Chapter 3

Fiscal Policy In Perspective

TAX REVISION is the principal instrument of U.S. economic policy to achieve prosperity and more rapid economic growth in the mid-1960's. The nature of that revision and the means by which it will accomplish its objectives have been described in the preceding chapter.

The aim and expectation of this program is to restore full prosperity, which, in the last analysis, is the only sure path to budgetary balance. Since this will, at least temporarily, involve large budgetary deficits, it is important also to examine what deficits mean in modern economic society. Government deficits are not a new fiscal experience for Americans. The first part of this chapter reviews several relevant aspects of that experience, and in particular distinguishes two kinds of deficits and their economic effects—deficits that grow passively out of economic recession or inadequate growth, and deficits that grow out of positive fiscal action, such as tax reduction, to invigorate the economy. The perspective is further widened by placing the Federal deficit or surplus in the context of balancing and offsetting deficits and surpluses in the other major sectors of the national economy.

Since deficits increase the national debt, it is important also to appraise that debt in relation to the Nation's wealth and the Nation's income. The national balance sheet allows us to view the Federal debt as one of a set of interrelated assets and liabilities.

Expansionary tax policy must be considered also in terms of the possible effects it may have on the stability of our price level. Not only is inflation unjust and disruptive, but it would interfere with our progress toward achieving balance in our international financial accounts.

These are some of the problems discussed in this chapter. They are problems which have been considered at length in the technical literature of finance and economics. But they become problems for all Americans to consider as the Nation prepares to take bold steps to invigorate its economy—steps involving large interim Federal deficits. Both experience and analysis confirm that this positive use of fiscal policy in 1963 will make a significant contribution to the achievement of our employment and growth goals and incur minimum risks of interfering with continued price stability and progress toward balance of payments equilibrium.

PASSIVE FISCAL POLICY AND AUTOMATIC STABILIZATION

Any weakening in private spending will reduce incomes, causing tax revenues to fall and transfer payments to rise. Thus disposable incomes will decline less than pre-tax incomes, and will be partly cushioned against the decline in private demand. In effect, the impact of the decline in private income is shared with the Federal Government, which does not shrink its purchases when its income falls. The greater the extent to which a fall in government revenues cushions the decline in private incomes, the less the flow of spending for output will be curtailed.

Automatic stabilization operates in reverse when private demand increases. Additional income is generated, but part of it is siphoned out of the spending stream in higher tax payments and lower transfers. Disposable incomes therefore rise less than incomes before taxes, and the spending and re-spending is limited and damped.

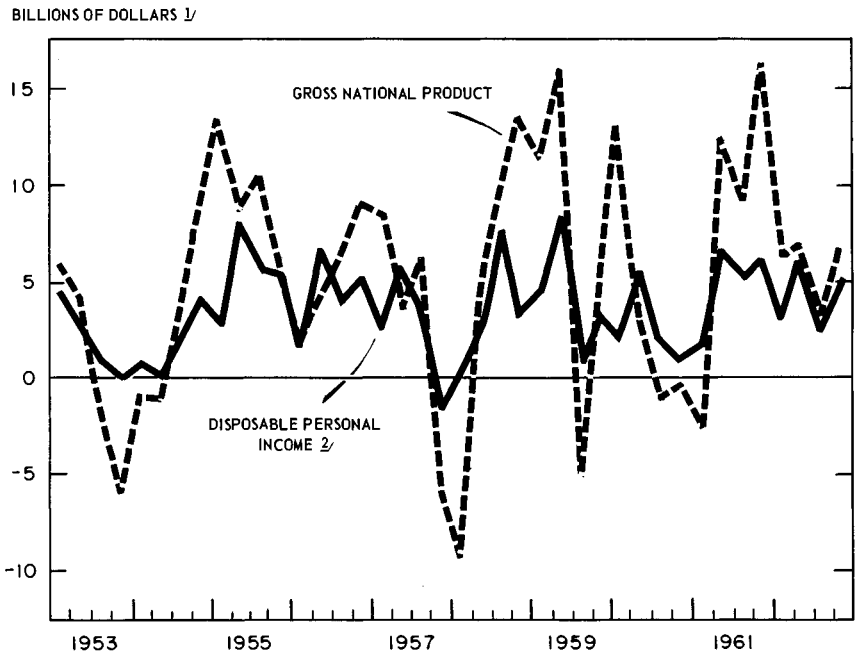
Thus the tax-and-transfer response narrows fluctuations in income caused by irregularities in the strength of demand. The sharper the response of tax collections to changes in GNP, the stronger the stabilization effect. Although the tax-and-transfer response cannot prevent or reverse a movement in GNP, it can and does limit the extent of cumulative expansions and contractions. At least with respect to contractions, this is clearly an important service to the economy.

Automatic fiscal stabilizers have made a major contribution in limiting the length and severity of postwar recessions. Each of the four postwar recessions—1948–49, 1953–54, 1957–58, and 1960–61—has been both short and mild. The decline in real GNP from its peak to its trough has ranged from a high of 4.4 percent in 1957–58 to a low of 2.1 percent in 1960–61, and the duration of the recessions has varied from 9 to 13 months. Chart 8 demonstrates that changes in disposable personal income from quarter to quarter have been much smaller than changes in GNP. Although GNP changes were frequently negative (in each of the postwar recessions), disposable income fell in only one quarter in the entire postwar period. This relative stability of personal disposable income has been mainly due to the automatic fiscal stabilizers, together with the tendency of corporations to maintain their dividends at the expense of retained earnings during recessions. The maintenance of disposable incomes has prevented sharp declines in consumer expenditures. The resulting stability in markets for consumer goods, which constitute by far the largest component of final demand, has prevented any drastic collapse in business investment in fixed capital.

Automatic fiscal stabilizers increase the stability of the economy. Stability is a desirable thing for an economy that is balanced where it wants to be. Thus, an economy operating, on the average, at high levels of output

CHART 8

Quarterly Changes in Gross National Product and Disposable Personal Income



1/ SEASONALLY ADJUSTED ANNUAL RATES.
2/ PERSONAL INCOME LESS PERSONAL TAXES.
SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

and employment benefits from a tax-and-transfer system highly responsive to changes in output and income, as a cushion against sharp movements of aggregate demand either toward inflation or toward recession.

However, in the present situation—with the American economy laboring for over five years well below its potential rate of output—automatic stabilization becomes an ambiguous blessing. The protection it gives against cumulative downward movements of output and employment is all the more welcome. But its symmetrical "protection" against upward movements becomes an obstacle on the path to full employment, throttling expansion well before full employment is reached.

Under such conditions, high employment can be restored—as is being proposed under the 1963 tax program—by a reduction in taxes. When this is done the need is not primarily to lessen the responsiveness of tax receipts to changes in GNP. Rather the whole schedule of taxes should be lowered—so that, at any given GNP, taxes siphon off less private purchasing power—while leaving the response of tax receipts to *changes* in GNP about as great as before. To be sure, it is almost impossible to lower taxes without lessening to some degree their sensitivity to changes in GNP. But the

purpose of such a change should be to lower the level of taxes—and hence their persistent drag on purchasing power—rather than to reduce their automatic countercyclical response.

TAX CUTS TO AID RECOVERY

Just as we have had postwar experience with automatic stabilization, we have had experience with active tax cuts which served positively to increase demand. These experiences are of interest in the present context.

In two of the postwar recessions—1948–49 and 1953–54—tax cuts helped to check the decline and to spur the ensuing recovery. Neither of the tax cuts is an example of deliberate countercyclical fiscal action, but both had important expansionary effects which came when they were needed.

Under the Revenue Act of 1948, which was passed by the Congress in April, taxes were reduced by $4.7 billion. While at the time, the tax cut appeared inappropriately timed—few observers were predicting recession—when the recession of 1949 in fact occurred, it turned out to be fortunate that the tax cut had been legislated. The cut was retroactive to January 1, 1948, and as a result refunds were exceptionally large in mid-1949. The upturn began in October 1949. In addition to the tax cut, there was a significant increase in Federal expenditures in late 1948 associated with the introduction of the Marshall Plan. This also helped to mitigate the recession. The economy was further stimulated in the expansion phase by the heavy increases in placement of military orders associated with the Korean War, which began in June 1950. As a result of the tax cut and the increased expenditures, together with the effects of the automatic stabilizers, the recession was short and mild, and the ensuing expansion was strong. By the first quarter of 1951, unemployment had been reduced to 3.5 percent of the labor force.

As a result of the rapid expansion, by the second quarter of 1950, Federal tax liabilities as shown in the national income accounts had risen substantially above the levels that prevailed at the time taxes were cut in the second quarter of 1948.

Taxes also were cut during the recession of 1953–54. Effective January 1, 1954, the excess profits tax was repealed, and personal income tax rates were reduced. Excise taxes were reduced on April 1, and further tax reductions for both individuals and corporations were embodied in the Internal Revenue Code of 1954. These measures are estimated to have reduced Federal revenues by about $6.1 billion (seasonally adjusted annual rate) in the first half of 1954. Further cuts which went into effect later brought the revenue loss on a full-year basis to about $7.4 billion. These cuts in personal and corporate income and excise taxes were partially offset, however, by an increase of about $1.4 billion (annual rate) in OASI contributions, which became effective on January 1, 1954. For the most part,

the tax reductions in 1954 were part of a program of tax reform and were not viewed primarily as fiscal policy measures aimed at countering the recession. Yet as a result of the tax cuts that became effective at the beginning of 1954, disposable personal income and personal consumption expenditures turned up in the first quarter, while personal income and GNP were still declining. It is generally agreed that the recession ended in August. Tax reduction, together with an easy monetary policy which made a plentiful supply of funds available to finance a strong expansion of housing and automobile demand, helped to shorten the recession and to invigorate the ensuing expansion which brought unemployment down to 4.2 percent of the labor force by the third quarter of 1955.

As a result of the expansion, by the first quarter of 1955 total Federal tax liabilities, as shown in the national income accounts, had risen significantly above the level that prevailed in the fourth quarter of 1953 before the tax cuts were put into effect.

While the tax cuts of 1954 helped considerably in rescuing the economy from the recession, it should be recognized that had they gone into effect earlier, the recession of 1953–54 might have been completely avoided. Government expenditures (principally defense spending) were cut by nearly $11 billion between mid-1953 and mid-1954. The tax cuts took effect 6 months after expenditures began to fall. As it was, fiscal policy, taken as a whole, was contractionary in this period and was a major cause of the recession. The Federal deficit as shown in the national income and product accounts was $7.0 billion (seasonally adjusted annual rate) in the second quarter of 1953 when the recession began. By the fourth quarter the operation of the automatic stabilizers associated with the decline in economic activity had increased the deficit to $11.8 billion despite significant cuts in expenditures. The deficit dropped to $10.6 billion in the first quarter of 1954, and as a result of sharp cuts in expenditures, to $5.4 billion in the second quarter despite the tax reductions that went into effect in the first half of 1954.

Private scholars who have studied the period have estimated that if the economy had continued to operate at the same rate of unemployment that prevailed in the second quarter of 1953, the budget deficit would have dropped from $7.0 billion in that quarter to $3.8 billion in the fourth quarter of 1953 and would have shifted to a surplus of $3.0 billion by the second quarter of 1954. This represents a shift of $10 billion between the peak of the previous recovery and the trough of the recession. It is an approximate measure of the net contractive effect of active fiscal policy during this period.

FISCAL POLICY IN THE 1930'S

During the 1930's, America had its longest uninterrupted experience with budget deficits. Their persistence, their relatively large size in comparison with GNP, and their association with an unprecedented unemployment

rate (averaging 18.2 percent from 1930–39) have sometimes been interpreted as demonstrating the futility of expansionary fiscal policy.

The 1930's were a tragic period in the Nation's history. The "Great Depression," the causes of which are still not fully diagnosed, produced a tremendous "gap" between actual and potential output—not the 6 percent average of recent years but about 40 percent during much of the period. In such an abnormal situation, it is perhaps too much to expect that fiscal policy alone could have fully offset a prolonged failure of the private economy to generate strong expansionary forces.

But in fact, active fiscal policy was not employed vigorously, consistently, or with proper timing. And whatever constructive impact fiscal policy may have had was largely offset by restrictive monetary policies and by institutional failures—failures that could never again occur because of fundamental changes made during and since the 1930's.

Briefly summarized, the facts are these:

(1) Fiscal policy was moderately expansionary for the decade as a whole. Federal expenditures increased substantially, adding to total demand. But most of the effect of this expenditure growth was offset by a series of very heavy tax rate increases, especially in the Revenue Acts of 1932 and 1936. Federal revenues increased by 77 percent over the decade even with a terribly depressed tax base. If the unemployment rate had stayed at the 1929 level, revenues would have more than doubled. The Federal budget changed from a surplus of slightly over $1 billion in 1929 to deficits that would have averaged less than $1 billion over the decade had unemployment been at the same level as in 1929. Of course, because of the collapse of the revenue base, actual deficits were much larger; but these were partly the passive product of depression and partly the reflection of an actively expansionary policy.

(2) At two crucial periods, fiscal policy shifted sharply in a contractionary direction: in 1932–33, and again in 1937–38. In the first period the contractionary policy coincided with and intensified the monetary collapse, and in the second choked off the 1937 recovery.

(3) State and local government budgets were then much larger than the Federal budget, and they were changed in a highly restrictive manner, shifting from a deficit in 1929 to surpluses after 1934.

(4) Unemployment melted away very rapidly when military needs began in 1941 to lead to large budget deficits. Of course, as these expenditures and deficits grew during the war, they not only restored full employment but became a serious inflationary danger. But this wartime overdose of expansionary fiscal medicine should not obscure the fact that more moderate dosages in the early stages quickly solved an unemployment problem which had seemed

insoluble for 10 years. This was not because the expenditures happened to be military in nature—any expenditures, private or public, on the same scale would have expanded demand and put men back to work.

SOME CONCLUSIONS FROM PAST EXPERIENCE

Several conclusions emerge from the preceding review.

The automatic stabilization which our present fiscal system provides is a powerful weapon to damp cyclical movements of output and employment. It is one of the factors that has kept the U.S. economy free from major depressions in the postwar period.

The postwar record shows that deliberate tax cuts can have a countercyclical impact, encouraging recovery by stimulating private demand. The experience reviewed above shows how in two cases tax reduction contributed in this manner to recovery from recession. The fact that these tax changes came at times when they helped to check recession and encourage recovery was, however, largely accidental.

The 1948 tax reduction was intended as a permanent one, reflecting the postwar decline of military expenditures. The 1954 tax cuts were also intended as a permanent adjustment to the sharp reductions in government expenditures at the end of the Korean emergency. But a recession will not always coincide with the need for permanent tax reduction. The temporary fluctuations in private demand that are commonly responsible for cyclical movements in business activity thus may call for temporary adjustments in fiscal policy that can be reversed as the need for them recedes.

Last year the President proposed two measures for greater fiscal flexibility to meet recessions. These were (a) a proposal that the Congress grant to the President limited authority to initiate temporary reductions in personal income tax rates, subject to Congressional approval; and (b) a proposal that the Congress give the President stand-by authority to accelerate and

TABLE 10.—*Federal Government surplus or deficit: Comparison of estimate and actual, fiscal years 1958–63*

[Millions of dollars]

Fiscal year	Date of estimate [1]	Administrative budget surplus or deficit (−)	
		Estimate [1]	Actual [2]
1958–63 average		1,411	−5,511
1958	1957	1,813	−2,819
1959	1958	466	−12,427
1960	1959	70	1,224
1961	1960	4,184	−3,856
1962	1961	1,468	−6,378
1963	1962	463	[3] −8,811

[1] Estimate in Budget document issued in January of year indicated.
[2] Actual, except for 1963.
[3] Estimate, January 1963.

Source: Bureau of the Budget.

initiate appropriately timed public capital improvements in times of serious unemployment. In his Economic Report the President has reaffirmed his support of the principle underlying these two proposals.

A weak private economy can generate very large deficits without receiving a positively stimulating effect from those deficits. The large passive deficits of the 1930's provide examples. More recent examples appear in the experience of the past 5 years. Although the administrative budgets presented for the fiscal years 1958–63 foresaw a surplus in every year, averaging $1.4 billion, the actual outcome has been a deficit in all but one of these years, averaging $5.5 billion. This record is summarized in Table 10. The discrepancy between the Administration's proposed budget and the actual fiscal outcome is, of course, accounted for by two factors: variance between actual and anticipated GNP, and Congressional action modifying both expenditures and taxes. But the major factor explaining these discrepancies was the failure of the economy to attain the GNP that had been anticipated.

Passive deficits are largest when the economy experiences recession. A recession which would reduce the expected GNP gains in fiscal year 1964 by even $15 billion below what they would otherwise be would add almost $5 billion to the deficit.

The experience of the last few years should make it clear that merely to incur deficits is not an appropriate objective of policy. For it is not the deficits as such that provide stimulus. Only reductions in tax rates or increases in expenditures have an actively stimulating role. The passive deficits which are the product of recession or slack, however, have a valuable cushioning function. Nevertheless, it is an appropriate objective of policy to eliminate the deficits that are the product of a recession or a sluggish economy—because of the human and economic waste that is involved in recessions and slack. The proper objectives of policy are full employment and growth, and recessions and slack are the opposites of these.

It is clear that the deficit which a slack economy or recession produces cannot realistically be eliminated by raising tax rates or by reducing government expenditures. Its source is not excessive spending or tax rates that are too low. The attempt to eliminate a deficit by these means would be largely self-defeating. Such a policy would be disastrous for employment, incomes, profits; the deficit would remain; and the role of the dollar as an international currency would be undermined.

Expenditures that are wasteful or represent improper fields for government action (something which only the public, acting through elected representatives, can determine) should surely be eliminated. But unless taxes were simultaneously reduced by more than expenditures decline, the effect would be contractionary on the economy. The beneficial effect on incentives through lower tax rates might be more than offset by a net loss in demand. A cut in expenditures reduces market demand directly by the full amount of the cut, while an equal reduction in taxes expands market de-

mand by a smaller amount, because a part of the reduction will be added to personal and business saving.

Deficits that result from recession or slack can be eliminated only by restoring and maintaining a vigorous, rapidly growing economy. If the tax system imposes an excessive drag on the economy—through its effects on purchasing power and on incentives—tax rates may be too high relative to expenditures, even though the budget is in deficit. Thus, tax revision, involving both reduction and reform, can not only provide stimulus for growth and prosperity, but can even, as a result, balance the budget or produce surpluses. Recession and slack generate deficits; prosperity and growth balance budgets.

The reciprocal relationships among surpluses and deficits in the Federal budget and the strength of the private economy can be clarified by examining the counterparts of the Federal budget for the other sectors of the economy.

DEFICITS AND SURPLUSES—PRIVATE AND PUBLIC

For the economy as a whole, expenditures on final output in any past period must necessarily add up to the value of total gross product or income. Therefore, if any one sector in the economy has incurred a deficit by spending more than it has received in income, some other sector must have incurred a surplus by spending less than it has received. Putting it differently, the sum of all sectoral deficits must be identical with the sum of all surpluses. The problem is to maintain a relationship between the deficits and surpluses of the various sectors that will permit this balance to be reached at a satisfactory level of economic activity—and without a prolonged succession of government deficits. The interrelationship between the levels of surplus and deficit of various sectors in the economy has been tabulated in the President's Economic Report each year since 1947. It gives an interesting insight into the cyclical behavior of the economy and places fluctuations in the Federal deficit or surplus in better perspective.

A Federal deficit on national income account means that the Government's injections into the stream of income and expenditures through purchases of goods and services and transfer payments exceed its withdrawals through taxes and social insurance contributions. Conversely, a surplus means that its withdrawals exceed its injections. (The way in which the Government uses its surplus or finances its deficit may have an important bearing on the level of business or even consumer expenditure. These transactions on asset account are not explicitly treated in the present analysis, but these vital considerations of financial policy are dealt with elsewhere in this Report.)

For consumers, receipts of disposable income are withdrawals, and outlays for consumption represent injections. Expenditures on residential construction, though usually treated in the national income accounts as

business investment, are here assigned to the consumer sector, and depreciation charges on residential property are treated accordingly as gross consumer saving.

State and local governments, as the Federal Government, withdraw purchasing power from the income stream through taxes, and inject it by purchases of goods and services and by transfer payments. The concept of surplus and deficit is the same as for the Federal Government. In the case of the foreign sector, imports of goods and services drain purchasing power away to other countries, while exports of goods and services for which payments must be made to the United States constitute injections.

For business firms, retained earnings and depreciation allowances (gross saving) are withdrawals from the gross income stream, while expenditures for fixed and inventory investment are injections. A "deficit," in these terms, exists if investment exceeds gross saving. Thus defined, a "deficit" on capital account does not mean that business is unprofitable—quite the contrary. Borrowing to finance investment in productive plant and equipment that yields a return over time lies at the heart of the growth process of the economy. In years of prosperity, when unemployment is low and capacity is fully utilized, business profits are high and the saving from retained earnings and depreciation allowances is relatively large. But in these years, the inducement to invest in new productive facilities is so strong that it substantially outruns even the large supply of internal saving.

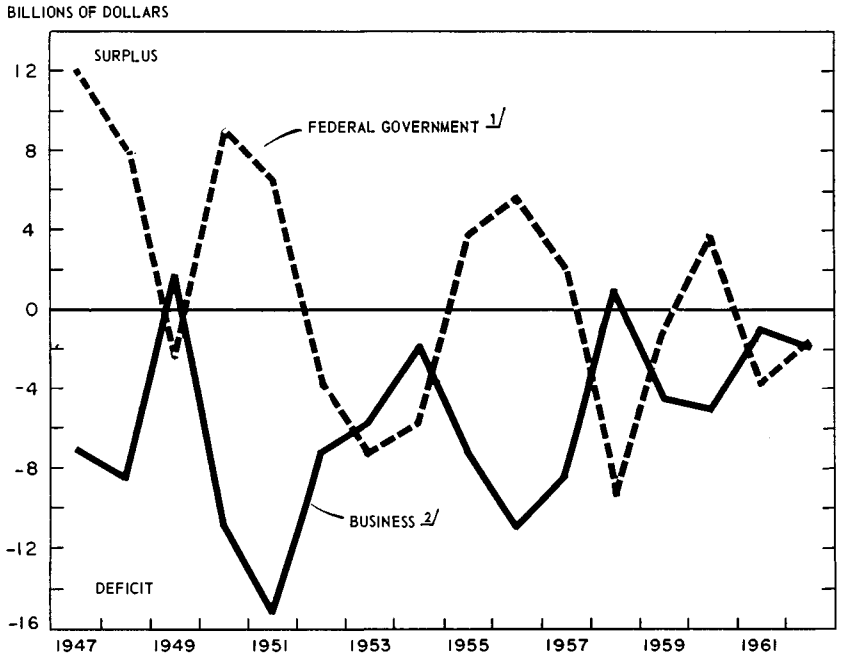
The "budget" of the consumer sector characteristically shows a surplus—an excess of disposable income plus depreciation of houses, over the combined total of personal consumption expenditures and residential construction. Indeed, during the period 1947–62, the consumer sector was in surplus in every year except 1947. The average surplus in that period was about $6.5 billion.

State and local governments have had deficits in 8 out of the last 9 years and in 11 of the entire 16 years under review. Their deficits have been relatively small, averaging a little less than a billion dollars in the last few years. The foreign sector has had an excess of current purchases from the United States over sales to the United States in 9 of the 16 years, and for the whole period the excess of purchases averaged a little less than a billion dollars a year. This excess of purchases is a deficit for purposes of the U.S. national income accounts.

Characteristically, the business and Federal Government sectors combined show a deficit, which offsets a consolidated surplus in the remaining sectors. However, the only two sectors whose deficits and surpluses exhibit fluctuations clearly related to changes in the general level of business activity are the business sector and the Federal Government. Chart 9 shows the deficit or surplus in the Federal national income accounts budget and the deficit or surplus of the business sector on capital account for each year from 1947 to 1962. The chart shows clearly that movements in the deficits and sur-

CHART 9

Federal Budget and Business Capital Account: Surpluses or Deficits



1/ SURPLUS OR DEFICIT (–) ON NATIONAL INCOME ACCOUNTS BASIS.
2/ EXCESS OF GROSS RETAINED EARNINGS (EXCLUDING DEPRECIATION ON NONFARM RESIDENTIAL PROPERTY) OVER GROSS PRIVATE DOMESTIC INVESTMENT (EXCLUDING RESIDENTIAL CONSTRUCTION), OR EXCESS OF GROSS PRIVATE DOMESTIC INVESTMENT OVER GROSS RETAINED EARNINGS (–). SEE TABLE C–7 FOR DATA AND DEFINITIONS OF EARNINGS AND INVESTMENT.

SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

pluses of these two sectors bear a marked inverse relationship. The year-to-year movements of the deficits or surpluses were in opposite direction for these two sectors in 12 of the 15 cases shown.

The budget of the business sector exhibits surpluses or small deficits in years of recession and slack, moves toward deficit as the economy expands, and commonly achieves a substantial deficit in years of prosperity and low unemployment. Consequently, it is in prosperous years, such as 1947, 1948, 1950, 1951, 1952, 1955, 1956, and 1957, that the business sector has had large deficits on capital account. It is in those years that business raises large amounts of funds on the capital market and uses the surpluses of other sectors. On the other hand, when there is substantial unemployment and unutilized capacity, as in the recession years 1949 and 1954 and the years 1958–62, the inducement to invest tends to be so weak that investment

spending falls, even relative to the reduced levels of gross retained earnings, and the business sector budget shows only a small deficit or even a surplus.

The Federal budget shows a reverse pattern. It consistently moves toward a surplus as the economy expands and toward a deficit as it contracts. These movements are mainly a passive result of the operation of the automatic fiscal stabilizers, though they reflect also active measures of fiscal policy aimed at minimizing economic fluctuations. As a general rule, the Federal Government has had budget surpluses in years when the unemployment rate has averaged less than 5½ percent of the labor force and budget deficits in years when the rate has exceeded that figure. The only exceptions to this rule between 1947 and 1962 were the years 1952 and 1953 when the requirements of the Korean war forced very high military expenditures in a time of prosperity and low unemployment, and the year 1960 when a deliberate contraction of Federal expenditures cut short recovery from the 1957–58 recession while unemployment was still high. On the other hand, in years when unemployment has exceeded 5½ percent, the business sector has had an average deficit of less than $2 billion, whereas in years in which unemployment has been less than 5½ percent the business sector deficit has averaged $9 billion.

It is evident that the deficit or surplus in the business sector is related to the surplus or deficit in the Federal Government sector. More important, it is a major determinant of the total level of expenditures and hence of economic activity. When capital spending is sluggish, the over-all level of expenditure, and hence income, is likely to be unsatisfactory. A passive deficit in the Federal sector will occur. But this, in itself, cannot provide the new inducement to investment that will restore full employment and in the process permit the Federal Government a surplus in its own accounts.

The business sector cannot, of course, be expected to run large deficits merely in order to maintain high levels of economic activity. General economic stabilization is a responsibility of the Federal Government, not of private business organizations. Unavoidable fluctuations in private demand make it almost certain that the Federal budget will show deficits in some years. But the way to avoid chronic Federal deficits and achieve surpluses with reasonable frequency is to pursue active Federal policies—including budget and tax policies—designed to keep the economy operating continuously at high levels of employment and capacity utilization.

PROSPECTS FOR THE FUTURE

There are many reasons for confidence that, once full employment is restored by fiscal action, the private sectors will once again find it to their advantage to increase investment and incur deficits sufficient to generate a balance in the Federal account—that the private economy will find new buoyancy which will make surpluses possible and appropriate.

The weakness of fixed business investment in recent years has reflected—and in turn reinforced—the slow and uncertain growth of aggregate demand. Greater utilization of existing capacity may not immediately yield a burst of investment activity. Businesses which expanded capacity in 1955–57 in the expectation of expanding markets and reaped only a harvest of higher overhead costs may be hesitant to bet again on sustained prosperity. But as strong markets are restored and maintained, business confidence can and will revive. Private investment will then be once again the primary force for economic growth. Structural factors will favor this development. For example, beginning in the second half of the 1960's demographic conditions will be ripe for one of the strongest and most prolonged booms in residential construction this country has ever known. The vast research and development effort of American industry will yield new techniques and new products which will be profitable to install in steadily expanding markets.

The historical record of the American economy—like that of every industrialized country—exhibits an irregular sequence of periods of strong and buoyant demand, alternating with intervals of weakness and slack. The reasons for this irregularity are many: massive innovations like the automobile or electrification, the opening or closing of new territories, bursts of population growth, the temporary drying-up of profitable investment opportunities. History teaches that all such periods end. The natural tendency to extrapolate the recent past ought not to blind us to the likelihood that the weakness of the past few years will sooner or later be transformed into strength. But if we fail to do what is needed now, the transformation may be long delayed.

TAX REDUCTION AND THE NATIONAL DEBT

Tax reduction in 1963 will, as indicated previously, lead to a transitional increase in the budget deficit. As a result, the total Federal debt will rise by an estimated $5.4 billion in the fiscal year 1963, from $298.6 billion in June 1962 to $304 billion in June 1963.

The significance of the public debt—and its increase in 1963—can be best understood by putting the debt in the context of the over-all economy and taking into account the development over time of both the debt and the economy.

World War II led to a $211.9 billion increase in total Federal debt outstanding—from $47.6 billion in December 1939 to $259.5 billion in December 1946, as shown in Table 11. By December 1962, the debt had risen by a further $44.5 billion. Since the war, its size relative to the total economy has declined by more than one-half: the ratio of the debt to GNP was 123 percent at the close of 1946, and at the close of 1962 it was 55 percent. The decline has been fairly steady and has continued in each of the last 2 years. While the absolute size of the debt will again increase during the

TABLE 11.—*Federal debt and interest payments on the debt, selected calendar years, 1939–62*

Item	1939	1946	1950	1955	1960	1962 [1]
	Billions of dollars					
Federal debt: [2]						
Total [3]	47.6	259.5	256.7	280.8	290.4	304.0
Held by the public [4]	38.6	205.3	196.7	204.3	207.9	217.6
Interest payments on debt:						
Total debt	1.0	5.0	5.6	6.5	9.3	9.6
Debt held by the public	.8	4.2	4.3	4.8	6.7	6.9
	Percent					
Debt as percent of gross national product:						
Total debt	52.3	123.2	90.2	70.6	57.7	54.9
Debt held by the public	42.4	97.4	69.1	51.4	41.3	39.3
Interest payments on debt as percent of national income:						
Total debt	1.4	2.8	2.3	2.0	2.2	2.1
Debt held by the public	1.1	2.3	1.8	1.5	1.6	1.5

[1] Preliminary estimates by Council of Economic Advisers.
[2] Amount outstanding, end of calendar year.
[3] Gross public debt and guaranteed issues held outside the Treasury.
[4] Total less amounts held by U.S. Government investment accounts and by Federal Reserve Banks.

Sources: Treasury Department, Department of Commerce, and Council of Economic Advisers.

fiscal year 1963, it will continue to decline relative to GNP: the growth of 1.8 percent in the debt will be less than the expected rise of 4.3 percent in GNP.

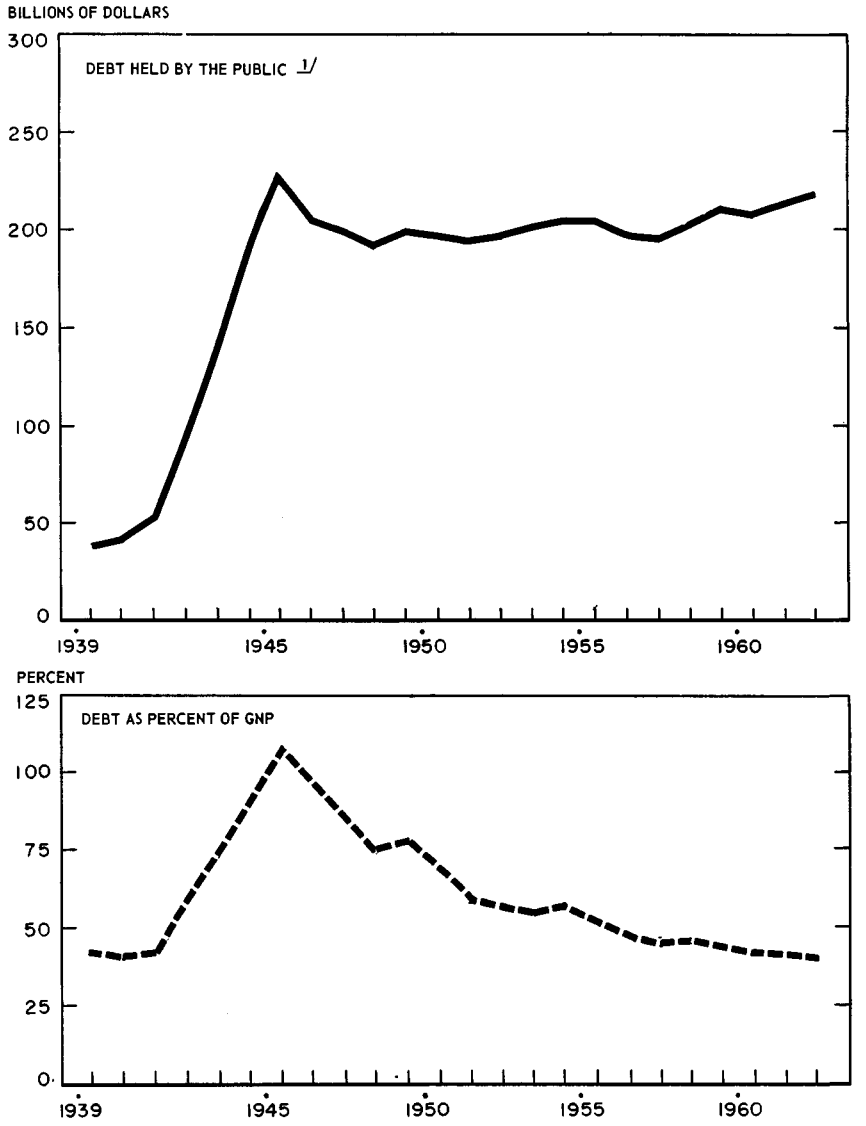
The absolute amount of interest payments shown in the administrative budget has risen from $5 billion in the calendar year 1946 to over $9 billion in the calendar year 1962, primarily because of the necessity of refinancing at higher current interest rates debt incurred during World War II. Such payments, however, have declined as a percentage of national income and as a percentage of total Federal expenditures during the postwar period.

Even in the perspective of the GNP, figures for *total* outstanding Federal debt and gross interest payments overstate the debt "problem." The total outstanding debt includes Federal securities held by the U.S. Government investment accounts—such as the social security trust funds—and by the Federal Reserve System. Interest payments on these components of the debt are, in effect, internal transfers of funds within the Federal Government itself and do not involve payments to the public. Moreover, debt held by the government investment accounts and the Federal Reserve does not pose a significant problem of debt management. The economically significant concepts are, accordingly, the publicly held debt, which excludes these components, and Federal interest payments to the public, which excludes interest transfers within the Government.

The publicly held Federal debt was $217.6 billion in December 1962, compared with total outstanding Federal debt of $304.0 billion. In the calendar year 1962, net Federal interest payments to the public were $6.9 billion, compared with the $9.6 billion of interest shown in the administra-

CHART 10

Federal Debt Held by the Public and its Relation to Gross National Product



1/ TOTAL GROSS PUBLIC DEBT AND GUARANTEED ISSUES LESS AMOUNTS HELD BY U. S. GOVERNMENT INVESTMENT ACCOUNTS AND BY FEDERAL RESERVE BANKS; END OF CALENDAR YEAR.

SOURCES: TREASURY DEPARTMENT, DEPARTMENT OF COMMERCE, AND COUNCIL OF ECONOMIC ADVISERS.

tive budget. From 1946 to 1962, the net increase in the publicly held debt was $12.3 billion, compared with the increase of $44.5 billion in the total outstanding Federal debt. (See Table 11 and Chart 10.) Net publicly held debt per capita fell from $1,450 in 1946 to $1,170 in 1962.

Since 1946, State and local governments in the United States have increased their net indebtedness fivefold—from $13.6 billion to $72 billion, or from $96 to $390 per capita. During this same period, total net private debt increased from $154 billion to an estimated $672 billion. Net corporate debt, accounting for one-half of this total, tripled its 1946 level, while individuals and noncorporate business increased their net indebtedness by over fivefold during this period. (See Appendix C, Table 51.)

Whether the increases in indebtedness in these sectors were wise or foolish depends not on the mere fact of an increase in their debt, but on the purposes achieved and on the future prospects of the individuals or organizations assuming the debt obligations. For the Federal Government, these same guides underlie our judgment as we decide whether an increase in the debt is appropriate. Federal expenditure programs must be rigorously judged on their merits. The decision as to the appropriate method of financing them, however, should be based on the Nation's economic condition, not on the object of the expenditure. In this respect the public debt is unique.

FEDERAL DEBT AND NATIONAL WEALTH

Our national wealth consists of real objects which yield direct services to us (such as the family automobile) or enable us to produce more or better goods and services (the machines in a factory). It also includes the amount by which Americans' claims on foreigners exceed foreigners' claims against Americans.

The measured national wealth, together with the skills and efforts of our labor force, constitutes the productive capacity of the American economy, the source of each year's output. In turn, the portion of annual output devoted to net investment equals the yearly addition to our national wealth—in the form of productive equipment, plants, houses, schools, post offices, and so on. The national wealth grows rapidly in prosperous years when investment is high and slowly in years of recession and slack. Thus, Table 12 shows that during the depressed 1930's national wealth actually declined; during both the prosperous 1920's and 1950's it increased substantially.

If our public debt were owned by foreigners, it would be a deduction from our national wealth and would place a direct burden on our economy by requiring us to export part of our total output to cover interest and amortization. But our public debt is nearly 95 percent internally held. Public debt held by Americans neither directly increases nor directly reduces national wealth. Also, it is not directly related to the asset holdings of

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TABLE 12.—*Civilian national wealth, selected years, 1900–58*

[Billions of dollars, 1947–49 prices]

End of year	National wealth [1]			Net foreign assets
	Total	Privately owned	Publicly owned	
1900	314.6	292.0	22.6	−6.9
1912	464.7	423.5	41.2	−4.8
1922	588.2	532.5	55.7	12.0
1929	778.0	700.2	77.8	18.2
1933	742.2	644.7	97.5	15.8
1939	748.4	623.2	125.2	3.1
1945 [2]	763.7	628.5	135.2	1.2
1945 [2]	788.4	647.1	141.3	−2.7
1946	812.9	671.7	141.2	3.0
1950	949.1	790.6	158.5	12.0
1954	1,086.3	907.8	178.5	12.8
1958	[3] 1,244.5	1,041.7	202.8	18.9

[1] Includes net tangible wealth and net foreign assets; excludes military assets.
[2] Two estimates for 1945: the first comparable with data for earlier years and the second comparable with data for later years.
[3] Total in 1958 prices is $1,702.8 billion.

Source: Raymond W. Goldsmith, *The National Wealth of the United States in the Postwar Period.*

the Government—although it may be noted that a recent report of the House Government Operations Committee estimates that the total wealth, including military assets, owned by the U.S. Government, exceeds its debt.

The tax program that is being proposed for enactment this year will bring about an increase in investment, both by raising demand and reducing excess capacity and by increasing incentives and the availability of funds. Thus, it will increase the accumulation of real capital and add to our national wealth.

Under other circumstances, of course, a fiscal policy which involved an increase in the public debt might operate to reduce real investment and retard the growth of national wealth. For example, when employment is high and demand is pressing against capacity, deficit financing of public noninvestment expenditures may contribute to inflation or raise interest rates and thereby depress private capital formation. Changes in national debt, therefore, bear no simple relation to changes in national wealth. An increase in national debt may indirectly spur the growth of wealth under some conditions and stifle it under other conditions.

THE BURDEN OF THE PUBLIC DEBT

An understanding of the relation between national debt and national wealth helps to place the problem of debt burden in further perspective. In what respects can it be said that public debt imposes a burden on either present or future generations?

1. As indicated above, the kind of fiscal policies we follow can either increase or decrease the living standards of future generations by affecting the stock of wealth we bequeath to them. But, clearly, the tax program being proposed for enactment in 1963, which

encourages both high employment and high capital formation for economic growth, will benefit future generations as well as our own. It will do so even though it results in some increase in the public debt.

2. At full employment, an increase in interest payments on the publicly held Federal debt will ordinarily require higher personal income and corporate profits taxes than would otherwise be necessary in order to prevent inflation. The resulting transfer from taxpayers to interest recipients does not constitute a direct draft on the real resources available to the American people as a whole, but it may impose a burden of a more subtle kind. By dampening incentives, the higher tax rates may reduce total output. How serious such a burden will be depends on the level of tax rates that is needed. In recent years, interest payments to the public by the Federal Government have amounted to less than 2 percent of the national income, as shown on Table 13. Moreover, the ratio of interest payments to national income has declined, and it is this ratio that matters in setting the required level of tax rates. Given the magnitudes of debt change involved in a fiscal policy for high employment, and relating them to the expected growth of our economy, it is likely that the debt burden will continue to decline.
3. A further potential disadvantage of debt service may result from its effects on income distribution. If all the debt were held by one group of investors while taxes were paid by a quite different group, undesirable distributional consequences might result. This, however, is not the case in the United States where debt-holding is fairly widely dispersed and our tax structure partially offsets the distributional effects of interest transfers.

Today's economic problem is slack, not inflation. Thus, under the present circumstances there is no reason to fear such increases in the public debt as tax reduction may entail. The ratio of interest payments on the debt to national income is small and is likely to fall, not rise. Nor is there any danger that the increase in the Federal debt will be a burden on future generations. Tax reduction will increase investment, and hence the wealth we will bequeath, not decrease it. The danger is the opposite one. By failing to take expansionary fiscal action, we will keep both consumption and investment depressed, thus hurting not only ourselves, but future generations as well.

PRICES, WAGES, AND THE BALANCE OF PAYMENTS

The primary purpose of the President's tax program is to strengthen greatly the forces of economic expansion, within an environment of contin-

ued price stability and improvement in our balance-of-payments position. The prospects are good that this can be accomplished by a proper combination of fiscal and monetary policies, continued adherence to sound wage and price policies, and even more intensive application of the measures already taken to improve our balance of payments position—particularly export expansion.

PRICES AND WAGES

Prices rise when demand exceeds supply. The most widely experienced form of inflation occurs when the demand for most or all commodities exceeds or is expected soon to exceed productive capacity. Inflationary pressures cannot directly result from passive deficits associated with economic slack and sluggish growth. The deficits of the past 5 years have occurred in a period of almost unprecedented stability of wholesale prices. Much larger deficits, as a proportion of GNP, were experienced during the 1930's, in a period of falling prices.

Active deficits, on the other hand, arise from policies designed to expand demand. An expansion of demand sufficient to achieve high employment tends to put pressure on prices and wages. But expansions which originate from tax reductions and which are associated with government deficits impose neither more nor less inflationary pressure than expansions originating in any other source. It is not the source of the increased demand, but the extent to which increased demand can be met without increases in costs, and the extent to which competition keeps prices in line with costs, that determine the effect of the expansion on prices and wages.

Effects of expansion on prices and wages

At present, considerable latitude exists in the American economy to increase output by bringing unemployed labor and unused capital back to work; this is a principal reason why a tax reduction is needed. While the record of the postwar years indicates that wages tend to rise more rapidly in years when unemployment is low, given the present high unemployment rate demand for labor can expand substantially without resulting in much additional pressure on labor markets.

In addition, competition is keen. Employers, labor, and the public all are aware of the dangers of cost inflation. The potential mobility of labor is high, and there are reasons to believe it will increase. In the years ahead a larger proportion of the total labor force will be new entrants, and their average educational level will be higher than ever before. New Federal programs of retraining, and other measures to increase the adaptability of the labor force have been introduced. These measures will be further strengthened in 1963 and the years ahead. These improvements in the adaptability of the labor force to changing demand conditions should permit relatively low levels of unemployment to be achieved before bottlenecks become serious.

Although wage pressures undoubtedly would be somewhat stronger at lower rates of unemployment, unit labor costs need not be higher because a considerable improvement in productivity would be the direct consequence of return to higher rates of capacity utilization. An underutilized economy incurs high costs relative to its output—the overhead costs of usable but unused plant and equipment, the cost of maintaining underutilized clerical and administrative staff, etc. All these costs are incurred whether production is low or high. Raising demand for goods and services will permit more efficient use of existing capacity and reduce underemployment of workers still on the payroll—in short, will increase the productivity both of labor and of capital. While higher demand will certainly pull some prices up and lengthen some delivery periods, reduced costs resulting from higher utilization of capacity in many industries will be a force on the side of stability. And in the longer run, the return to full employment, by stimulating investment in new plant and equipment, and the technical improvements it makes possible, will help to speed up the long-run advance in productivity and thus help stabilize or reduce unit costs.

Moreover, the world supply situation for primary products suggests stability in the prices of internationally traded raw materials. Thus substantial expansion of production in the United States can take place without upward pressure on costs from that source.

The extra gain in productivity associated with higher utilization will permit increased profit margins without price increases, provided wage rate increases do not outrun gains in productivity. Total profits will increase even more as sales rise. It is important that the push from the side of profits, like the push from the side of wages, be restrained within limits consistent with over-all stability. Stiff competition from abroad has already disciplined the price policies of a number of American industries and will continue to do so. In addition, a resolute policy of maintaining competition and encouraging the mobility of capital and enterprise as well as labor can make an important contribution in containing inflationary pressures.

A return to low unemployment after the recent period of price stability is unlikely to be encumbered by the same degree of inflationary psychology as earlier postwar periods of low unemployment.

Wage and price "guideposts"

To aid public understanding, the 1962 Economic Report concluded (pp. 185–90) with a set of "guideposts for noninflationary wage and price behavior." These guideposts were designed to provide standards for evaluating those price and wage decisions where the public has an interest in their content and consequences. They cannot, and should not, replace the normal processes of free private decisions and negotiations.

As the margin of unemployed labor and idle capital narrows, and as markets for goods and services become tighter, the guideposts will gain

in importance. They are restated here in the belief that an enlightened public understanding of the nature and causes of inflation would be an additional force minimizing any inflationary threats in the years ahead.

The guideposts themselves involve *general* guides for noninflationary wage and price behavior, subject, in each case, to a number of important and specific *qualifications* required by the objectives of equity and efficiency.

The general guide for wages 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." Under these conditions the gain from increases in productivity throughout the economy would be shared between wage and nonwage incomes by allowing each to grow at the same percentage rate. Each sector of economic life would share in the gains of advancing productivity. The qualifications call for faster increases in wage rates in an industry that (a) would otherwise be unable to attract sufficient labor to meet demands for its products, or (b) currently pays wage rates exceptionally low compared with those earned elsewhere by labor of similar ability. Symmetrically, increases in wage rates would fall short of the general guide rate in an industry that (a) could not provide employment for its entire labor force even in generally prosperous times; or (b) currently pays wage rates exceptionally high compared with those earned elsewhere by labor of similar ability.

The general guide for prices is that prices should fall in an industry whose rate of productivity increase exceeds the over-all rate, rise in the opposite case, and remain stable if the two rates of productivity increase are equal. The qualifications call for a faster price increase or slower price decrease in an industry in which (a) the level of profits is insufficient to attract the capital required to meet expansion of demand, or (b) costs other than labor costs have risen. On the other hand, increases in price would be slower or decreases faster than indicated by the general guide in an industry in which (a) productive capacity exceeding full-employment demand shows an outflow of capital to be desirable, or (b) costs other than labor costs have fallen, or (c) excessive market power has resulted in rates of profit substantially higher than those earned elsewhere on investments of comparable risk.

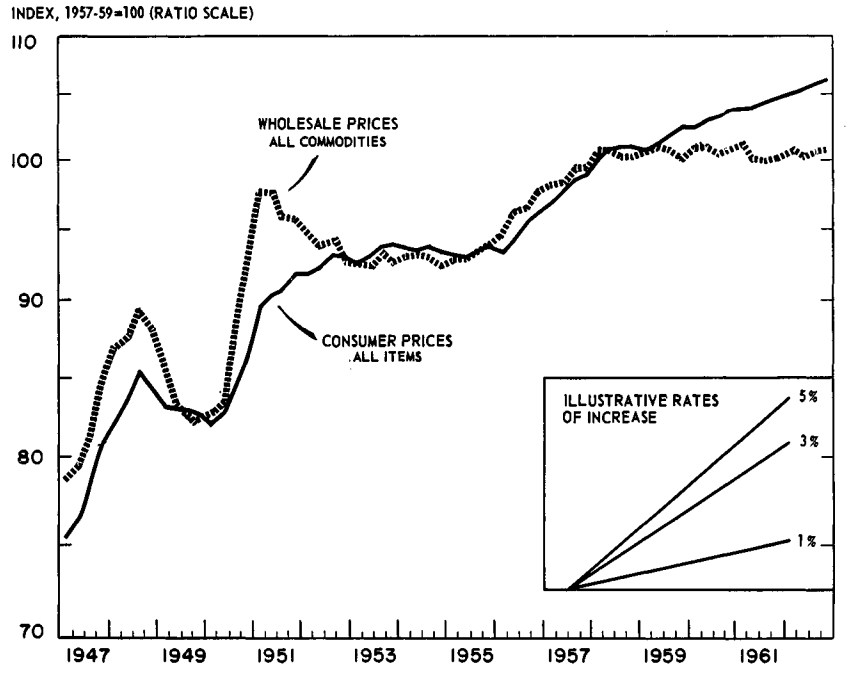
The recent record

Inflationary pressures in the American economy have receded since 1957. Between the first quarter of 1947 and the first quarter of 1958, wholesale prices increased at an annual rate of 2.2 percent, and consumer prices at 2.6 percent. Between the first quarter of 1958 and the last quarter of 1962, however, these annual rates of increase had fallen to 0.1 percent and 1.2 percent, respectively (Chart 11).

Between 1958 and 1959 a decline in wholesale prices of farm products and processed foods offset a slight increase in the average of all other wholesale prices. Since 1959, wholesale prices of all groups have been

CHART 11

Price Developments in the Postwar Period



SOURCE: DEPARTMENT OF LABOR.

essentially unchanged. Within the total of consumer prices, service prices continued to rise more rapidly than the average, but there has also been some slowing in the rate of increase of service prices. When it is recognized that improvements in the quality of goods and services are only imperfectly allowed for, the 5-year record of the consumer price index, and its several components, is cause for satisfaction.

The principal threat to the continuation of price stability in 1962 occurred in April when a general increase in steel prices was announced by a number of the major producers. This increase followed the agreement in March on a wage contract generally regarded as noninflationary. Had this increase stood, it would have caused and invited other price increases throughout the economy; it would have led organized labor to adopt a new militancy in its wage demands; and it would have seriously weakened the forces working toward the restoration of our international competitive position. Fortunately, the price increase was rescinded after the President expressed the country's concern over the serious threat to price stability and our balance of payments.

TABLE 13.—*Changes in hourly earnings in manufacturing industries, 1947–62*

Period	Percentage change per year [1]
1947 I to 1962 IV [2]	4.7
1947 I to 1958 I	5.5
1947 I to 1949 III	8.0
1949 III to 1954 III	4.9
1954 III to 1958 I	4.3
1958 I to 1962 IV [2]	2.9
1958 I to 1961 I	3.4
1961 I to 1962 IV [2]	2.2

[1] Change in average hourly earnings of production workers, adjusted to exclude overtime and inte industry shifts. Quarterly data not available prior to 1959; first month in quarter used.
[2] Preliminary estimates by Council of Economic Advisers.

Source: Department of Labor (except as noted).

The rate of annual increases in average hourly earnings in all manufacturing, adjusted to exclude overtime and interindustry shifts, has declined steadily throughout the postwar period, and the rate of increase has been considerably reduced in the past 5 years.

As is shown in Table 13, average hourly earnings rose 5.5 percent a year between 1947 and 1958, and only 2.9 percent a year between 1958 and 1962. This pattern needs, of course, to be interpreted in the context of the concurrent slowdown in the rate of increase of consumer prices. Labor costs per unit of output in all manufacturing have been stable or declining since 1958, whereas in the earlier period they had advanced.

The fact that these developments have occurred under the cloud of a 5-year underutilization of resources warns against overconfidence in their continuation. But sober confidence that expansionary policies can proceed without fear of premature revival of inflationary pressure is justified by the fact that price stability has been maintained through the second year of cyclical expansion.

BALANCE OF PAYMENTS

Chapter 4 discusses the impact of economic expansion on the balance of payments. The main point to be made here is that the immediate effects on the balance of payments of an expansion of domestic economic activity brought about by fiscal measures are no different from those produced by an expansion finding its origin in a spontaneous increase of private demand. However, the 1963 tax program, in addition to expanding total demand, will strengthen incentives, thereby increasing investment, decreasing unit costs, and helping our international competitive position.

Stability of prices is particularly important for the balance of payments. It should be emphasized, however, that what is significant for America's competitive position in international trade is not the absolute change in the level of U.S. prices, but rather the change relative to prices abroad. In the

past several years, prices in the principal industrial nations of the world have risen relative to ours and indications are that this tendency will continue.

Perhaps the most important impact of economic expansion on the balance of payments will be through increased confidence around the world in the strength of the U.S. economy and thus in the strength of the dollar. Such confidence cannot be bred by the perpetuation of a sluggishly growing U.S. economy, subject to frequent recessions and incomplete recoveries.

Until recently there was widespread belief that foreign businessmen and private and central bankers would be frightened by expansionary fiscal policies and budget deficits in the United States. Fears of inflation and intensified balance of payments difficulties, it was said, would drive short-term capital funds from the United States and lead central banks to convert more and more of their increasing dollar holdings into gold. But in part through the joint studies and activities of the United States and its partners in the Organization for Economic Cooperation and Development (OECD) a better understanding now exists abroad of American prospects and policies. While there is an alert concern that inflation might again develop, important segments of European opinion now realize the urgency of expansionary U.S. fiscal policy—not only to strengthen the U.S. economy but to support the world economy and the international payments system based on the dollar.

In recent months, the OECD has recommended vigorous fiscal action to revive a strong and growing U.S. economy. For example, the annual OECD Economic Survey of the United States (issued December 13, 1962) concluded its review as follows:

> At the risk of over-simplification, the conclusions of this survey may be summarized as follows:
>
> i) The United States needs to raise its growth rate substantially above that experienced since the middle of the 1950's * * *
>
> ii) The major problem underlying the unsatisfactory experience of recent years has been the persistent weakness of demand * * *
>
> iii) It seems unlikely that demand from the private sector will, by itself, prove sufficiently buoyant to put the economy back on to a more appropriate long-term growth trend * * *
>
> iv) Under these circumstances, a greater stimulus from the Federal budget would seem necessary to offset the weakness of private demand, a stimulus that could be provided by tax reductions, by higher Federal expenditure, or by a combination of the two. This may well entail some temporary resort to deficit budget financing; but the quicker the economy regains the full-employment level the shorter will be the period during which deficits are incurred. It is greatly to be hoped that the fiscal changes to be proposed to Congress in 1963 * * * will be adequate in scope and timing to permit the early absorption of the present slack in the economy.
>
> v) In the short run stronger expansion involving increased imports will tend somewhat to decrease the balance of payments surplus on current account. But the government's efforts to promote exports and increase invisible earnings should counteract this tendency, given the cooperation of other Member countries. Rising activity at home should somewhat reduce the outflow on capital account, increasing the attractiveness of investment at home relative to investment abroad. Confidence in the dollar depends in good part on a strong domestic economy; it is unlikely to be fostered for any length of time by policies which keep the level of activity low.

As is clear from the final paragraph, our European and Canadian partners in the OECD recognize that stronger expansion might tend to intensify balance of payments problems in the short-run, and they are concerned that U.S. monetary and debt management policies should take appropriate account of these problems—as indeed they have in the past and will in the future. But our foreign friends also recognize—as most segments of domestic opinion now agree—that the problems prosperity will bring are far less serious than the problems it will solve.

The United States can stand prosperity.