

**THE ANNUAL REPORT  
OF THE  
COUNCIL OF ECONOMIC ADVISERS**



LETTER OF TRANSMITTAL

COUNCIL OF ECONOMIC ADVISERS,  
*Washington, D.C., January 10, 1969.*

THE PRESIDENT:

SIR: The Council of Economic Advisers herewith submits its Annual Report, January 1969, in accordance with Section 4(c) (2) of the Employment Act of 1946.

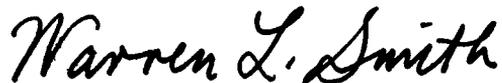
Respectfully,



ARTHUR M. OKUN,  
*Chairman.*



MERTON J. PECK.



WARREN L. SMITH.



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## CHAPTER 1

# Strengthening the Foundation of Prosperity

**T**HE AMERICAN ECONOMY achieved large gains in output and employment in 1968, as it continued to expand through an unprecedented eighth consecutive year. The value of the Nation's total output of goods and services—gross national product (GNP)—rose by \$71 billion from 1967 to 1968; after adjusting for price increases, the gain amounted to 5 percent. Employment grew by 1½ million persons, and in December the unemployment rate was down to 3.3 percent, the lowest since the early 1950's. The number of persons below the poverty income line declined by 4 million, the largest such reduction in any year on record. Meanwhile, our over-all balance of international payments improved markedly.

In part, however, this exuberance was too much of a good thing. The productive capability and adaptability of the American economic system were once more demonstrated; but the economy was severely tried by all of the demands placed upon it. The pressures of excessive demand pushed up the price level at the unacceptable rate of nearly 4 percent. Imports were drawn in from abroad at a very rapid pace, easing some domestic supply shortages but causing a sharp deterioration in the Nation's international trade surplus. And domestic financial markets came under renewed heavy pressure, producing sharp increases in interest rates.

The excessive buoyancy reflected, in large part, the extended delay in enacting the 10 percent income tax surcharge which had been proposed by the President in August 1967. While the fiscal program was pending, restrictive monetary policy took some of the steam out of the economy. But by the time the appropriate fiscal restraint went into effect in mid-July, the underlying forces of expansion had attained great momentum—more than was realized at the time. As a result, the needed moderation in the pace of advance developed slowly.

With inflationary pressures still strong, economic policy should continue to exert restraint in 1969. Total demand must be brought into better balance with the Nation's productive capacity to permit a slowing of price and cost increases. But the restrictiveness of policy should be tempered to preserve our basic prosperity; it should ensure that output continues to grow, although at a rate somewhat less than the growth of the economy's potential. The Administration's fiscal program is designed to meet these objectives.

The remainder of this chapter reviews developments in 1968 in more detail, sets forth the Administration's fiscal program for 1969, and finally summarizes the outlook in 1969 for economic activity, prices and wages, and the balance of payments. The other four chapters of this Report review some of the lessons of economic policy derived from recent experience and discuss some of the challenges of the future. The evolving role of fiscal and monetary policies in the 1960's is discussed in Chapter 2. The challenge of achieving price stability in a high employment economy is the subject of Chapter 3. International economic progress and problems are dealt with in Chapter 4, while Chapter 5 is concerned with the reduction of poverty. This volume also contains a report on economic planning for the end of hostilities in Vietnam.

## ECONOMIC GAINS IN 1968

The record of 1968 reflects both sides of the performance of an overly buoyant economy: the benefit to most Americans from large gains in real income and output, and the substantial cost of inflationary pressures.

### PRODUCTION AND PRODUCTIVITY

The 5 percent growth of real output achieved in 1968 was impressive in view of the already high level of resource utilization at the beginning of the year. But inflationary pressures were accentuated and, as shown in Chart 1, higher prices accounted for \$31½ billion of the \$71 billion rise in total GNP.

The rise in total real output was accomplished in part by a strong recovery of productivity growth in the private sector over the previous year—3.3 percent compared with 1.6 percent in 1967. In early 1967, many business firms had maintained high levels of employment in the expectation that the then emerging slowdown in production would prove temporary. Thus the diminished pace of the expansion was reflected in a slowing of productivity growth rather than a sharp rise in unemployment. Accordingly, with the resurgence of economic activity late in 1967 and in 1968, it was possible to meet some increased demand by fuller use of the existing work force.

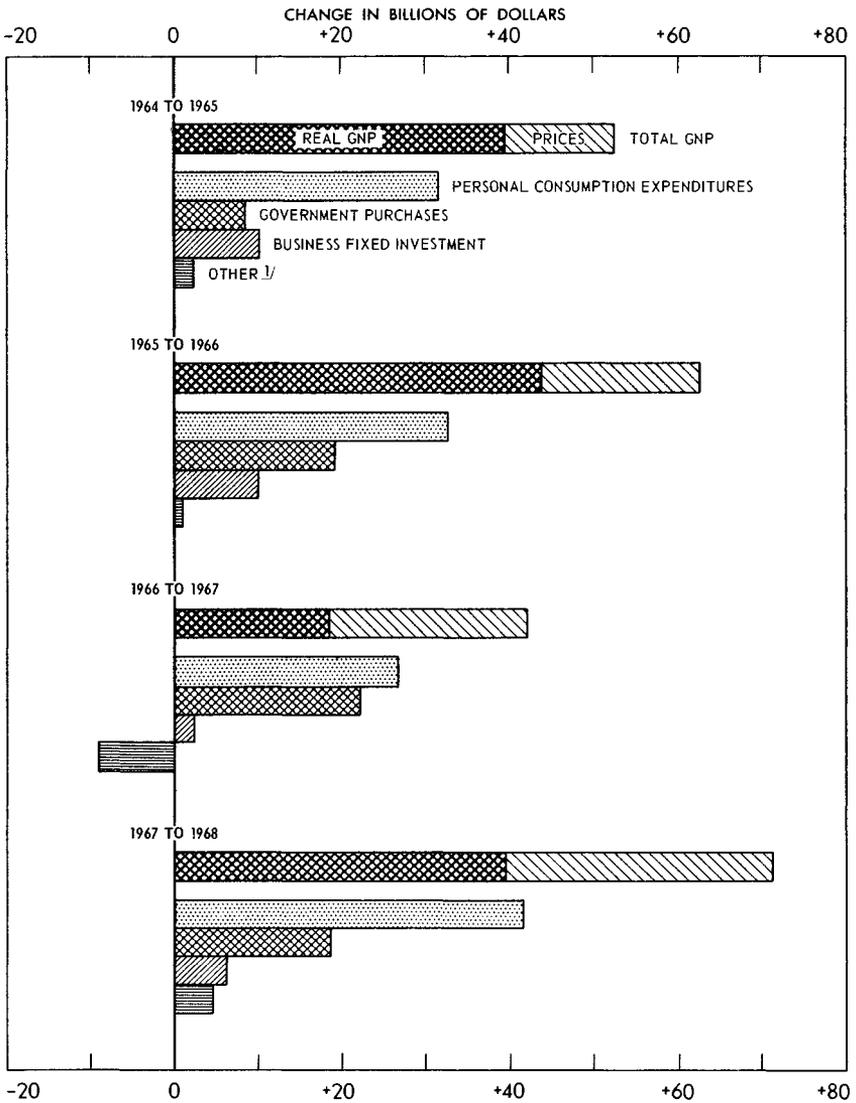
### EMPLOYMENT AND INCOME

As a result of the expansion, the unemployment rate fell to a 15-year low of 3.6 percent in 1968 compared with 3.8 percent in both 1966 and 1967, and the number of unemployed declined by 160,000.

Workers on nonfarm payrolls increased by 2.1 million in 1968. The largest gains occurred in State and local government payrolls, which increased by nearly 565,000 workers, and in trade and private services, which together added 950,000 workers. Manufacturing employment rose a relatively moderate 300,000. The Federal Government's civilian work force remained practically unchanged from 1967, while 100,000 persons were added to the Armed Forces.

Chart 1

# Changes in Gross National Product Since 1964



1/ RESIDENTIAL STRUCTURES, CHANGE IN BUSINESS INVENTORIES, AND NET EXPORTS OF GOODS AND SERVICES.  
SOURCE: DEPARTMENT OF COMMERCE.

With higher employment and more rapid wage increases, total wages and salaries increased by \$40 billion in 1968. A sharp \$7 billion rise in transfer payments, plus gains in dividends, interest, and rental income, added further to household purchasing power. Thus over-all personal income registered a large increase of \$57 billion over 1967. On an after-tax basis, and after correcting for price increases, income per capita increased by 3 percent in 1968—well above the average annual increase for the postwar years as a whole.

Corporate profits also rebounded sharply from their decline in 1967. Before-tax profits increased by more than \$10 billion. The 10 percent Federal income tax surcharge, enacted in June and made retroactive to January 1 for corporations, held the after-tax gain to \$3 billion. Particularly large gains were recorded by the manufacturing sector.

## THE COMPOSITION OF DEMAND

In contrast to the experience in many other years, the excessive expansion in 1968 was not attributable to any particular component of expenditures. Most components advanced, and they added up to a total of too much demand—what has been called a “well-balanced excess.”

### *Investment Sectors*

Residential construction outlays rose by \$5½ billion in 1968. As shown in Table 1, the proportion of total GNP accounted for by residential building

TABLE 1.—*Gross saving and investment in selected years of relatively high employment, 1952–68*

Source or use of saving	Percent of gross national product					
	1952	1956	1965	1966	1967	1968 <sup>1</sup>
<b>Private sector:</b>						
Gross investment.....	14.9	17.1	16.4	16.5	14.7	14.8
Business fixed investment.....	9.1	10.4	10.4	10.9	10.6	10.5
Residential structures.....	5.0	5.2	4.0	3.3	3.1	3.5
Change in business inventories.....	.9	1.1	1.4	2.0	.8	.9
Net foreign investment.....	-.1	.4	.6	.3	.2	( <sup>2</sup> )
Gross saving.....	15.4	16.2	16.5	16.7	16.9	16.1
Personal saving.....	5.2	4.9	4.1	4.4	5.1	4.7
Gross business saving.....	10.2	11.3	12.4	12.3	11.8	11.3
Excess of private saving or investment (-).....	.5	-.9	.1	.2	2.2	1.3
<b>Government sector:</b>						
Federal surplus or deficit (-).....	-1.1	1.4	.2	.1	-1.6	-.6
State and local surplus or deficit (-).....	( <sup>2</sup> )	-.2	.1	.1	-.2	-.1
Government surplus or deficit (-).....	-1.1	1.2	.3	.2	-1.7	-.7
Statistical discrepancy.....	.6	-.3	-.5	-.4	-.4	-.5

<sup>1</sup> Preliminary.

<sup>2</sup> Less than 0.05 percent.

Sources: Department of Commerce and Council of Economic Advisers.

recovered notably in 1968, although it remained far below the 4.3 percent average of the 1961–65 period.

Business fixed investment increased 7½ percent, but was not a strong stimulative force in 1968. Its share of GNP fell slightly from 1967 to 1968, in contrast to its usual rise in a year of rapid expansion.

Inventory accumulation played a relatively passive role in 1968, at least in comparison with the very sharp swings that were experienced in late 1966 and early 1967. Inventory-sales ratios were at a fairly normal level throughout much of the year.

The net export balance declined to its lowest level since 1959. Exports of goods and services rose \$5 billion. But imports of goods and services surged by \$7 billion in response to the expansion of domestic demand. The increase in imports amounted to nearly 10 percent of the increase in GNP—about twice the normal share of total imports in GNP.

### *Government*

The growth of Federal purchases for national defense slowed substantially. The \$6½ billion rise from 1967 to 1968 was far below the average of \$11 billion a year between 1965 and 1967. Nondefense purchases of goods and services increased by \$3 billion.

Purchases of goods and services by State and local governments continued their rapid growth of recent years with a \$9 billion increase. These expenditure increases were heavily concentrated in higher employee compensation payments, reflecting the growth of State and local employment.

### *Personal Consumption Expenditures*

Consumer expenditures turned out to be an important expansionary force in the economy in 1968, in contrast to 1967. The over-all rise of \$42 billion (8.6 percent) was marked by a strong \$10 billion advance in durable goods purchases. Automobile sales rebounded from the mild decline of 1967, with total sales of 9.6 million new cars exceeding the previous 9.3 million record of 1965. The rate of consumer saving fell to 6.9 percent of disposable personal income from the unusually high 7.4 percent reached in 1967.

## ECONOMIC POLICY IN 1968

The buoyancy of public and private demand and the resulting buildup of inflationary pressures that developed after mid-1967 accentuated the urgent need for fiscal restraint. However, enactment of such restraint was long delayed, complicating the management of monetary policy and enabling inflationary tendencies to become entrenched.

## FISCAL POLICY

The economic background of fiscal policy in 1968 had its roots in developments in early 1967. Although over-all economic growth was proceeding only slowly at that time because of an inventory adjustment, it was apparent that underlying forces of expansion were strong. These were expected to become more dominant in the second half of the year, once the inventory adjustment had run its course. Accordingly, the President proposed, in his Budget Message of January 1967, a temporary 6 percent surcharge on individual and corporate income taxes, to take effect on July 1, 1967.

By the second half of 1967, the prospect that excessive expansion was on the way became more apparent. Accordingly, in early August, the formal message requesting prompt enactment of the surcharge—revised to 10 percent—was sent to the Congress. However, the economy was not actually expanding at an excessive rate during the summer and early autumn, and the Congress was reluctant to take major action on the basis of a forecast of acceleration. No action was taken, and the fiscal impact remained strongly and inappropriately expansionary.

The pace of economic expansion did in fact accelerate, and the President renewed the request for a 10 percent tax surcharge in January 1968. The evidence of excessive demand, rising prices, deteriorating trade performance, and growing financial pressures at home and abroad became compelling. An international financial crisis developed in March, and by mid-May accelerating credit demands had pushed interest rates to record high levels. Even after a rather general consensus on the need for fiscal restraint developed, there were further delays in reaching agreement on the form of restraint. Some legislators were prepared to vote for higher taxes only if accompanied by cutbacks in Federal spending; others only if a tax increase would serve as a means of avoiding such cutbacks.

Congressional approval finally came with passage of the Revenue and Expenditure Control Act of 1968, signed into law by the President on June 28.

The Act provided for the 10 percent surcharge as requested by the President in January, with effective dates made retroactive to January 1 for corporations and April 1 for individuals. Since the withholding rate under the personal income tax was raised on July 15, many individuals will receive reduced refunds or have to make additional final tax payments early this year to cover the retroactive portion of the tax.

The Act also established specific limitations on Federal budget outlays for fiscal year 1969. Certain programs—support for Vietnam operations, interest on the public debt, veterans benefits and services, and social security benefits—were exempted from the limitations. Expenditures in the remaining categories were required to be reduced by \$6 billion below the levels contained in the January Budget.

As a result of the enactment of this fiscal program, the Federal budget (as measured in the national income accounts) has shifted from a deficit of \$11 billion in fiscal 1968 to one of only \$1 billion (annual rate) in the second half of calendar 1968. The tax surcharge alone is currently withdrawing about \$10½ billion (annual rate) from the income stream.

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

## MONETARY POLICY AND FINANCIAL DEVELOPMENTS

The Federal Reserve tightened credit in the first half of 1968 when little progress was made toward passage of the tax bill. In doing so, however, it attempted to steer a narrow course. There was hope for the enactment of fiscal restraint and hence good reason to avoid an extremely tight credit policy. On the other hand, it was necessary for monetary policy to help in cooling off the feverish economy in the short run and also to be ready to assume the full burden of restraint if the fiscal program should fail. Within these limitations, a series of actions did, in combination, achieve significant restraint.

Two half-point increases brought the Federal Reserve discount rate to a modern high of 5½ percent by late April. Regulation Q was also changed in April to raise the maximum allowable interest rates that banks could pay on time certificates of deposit. Open market operations brought pressures on bank reserve positions sufficient to slow bank credit growth to a 6½ percent annual rate in the first half of the year, compared with an 11½ percent increase in 1967. In the first half of 1968, total funds raised in credit and equity markets were 17 percent below the volume of the last half of 1967. Interest rates in the open market moved sharply upward. By late May, the rate on 3-month Treasury bills reached 5.90 percent and high-grade corporate bonds commanded more than 7 percent—above the highs during the 1966 credit crunch.

Interest rates fell for a time after the logjam on the tax bill broke in late May. The Federal Reserve followed this with some relaxation of its grip on bank reserve positions in June and July. In mid-August, the discount rate was reduced to 5¼ percent, largely in technical realignment to lower market rates.

The initial easing of pressures on the banking system set off widespread expectations that monetary policy would soon be eased still further. The resulting increased demand for securities to capture potential capital gains drove interest rates sharply downward. Meanwhile, the demands for credit to finance security purchases were added to the already heavy credit demands from the Treasury and the private sector, with the result that growth of bank credit accelerated sharply after midyear.

Federal Reserve policy continued to accommodate a good part of the rising demands for credit, but not to the extent of preventing further increases in market interest rates. By early October, most rates had climbed more than half way back toward their May peaks. Then, in mid-December, the discount rate was restored to 5½ percent. Toward yearend, the rate on 3-month Treasury bills was up to a new high of about 6.30 percent, a full percentage point above the level prevailing at the year's start, and most other market rates were at their highs for the year and for recent times.

## PATTERN OF ACTIVITY DURING THE YEAR

The record of expansion during the year reflects substantial adjustments in the behavior of the various sectors of the economy.

### UPSURGE DURING THE FIRST HALF OF 1968

GNP increased by \$42 billion (annual rate) between the fourth quarter of 1967 and the second quarter of 1968. As shown in Table 2, that surge was fueled by an extraordinary increase of \$39½ billion in final sales.

This was in contrast to the last half of 1967, when an important stimulus had come with a rise in inventory investment from its very low rate earlier in the year. In the first half of 1968, increases in inventory investment contributed only \$2½ billion, much of which reflected a buildup of stocks in anticipation of a possible strike in the steel industry.

Government expenditures were the most important expansionary force during the first half of 1968. Federal purchases of goods and services rose \$6½ billion (annual rate) from the fourth quarter of 1967 to the second quarter of 1968, reflecting a renewed acceleration in defense spending. State and local purchases increased more rapidly than usual, rising \$5½ billion over the period. A liberalization of Federal social security benefits took effect in March and contributed a major part of the \$5 billion increase in transfer payments during the period. The Federal fiscal impact remained strongly expansionary, even though revenues rose sharply with the booming advance of economic activity.

Most areas of private demand made relatively little contribution to the expansion. Business fixed investment rose \$2 billion, barely keeping pace with price increases. After its strong advance during 1967, residential construction leveled off, reflecting a tight monetary policy. Net exports declined, as imports expanded rapidly. Personal consumption expenditures grew nearly in pace with disposable personal income between the fourth quarter of 1967 and the second quarter of 1968.

Real GNP expanded at an annual rate of 6½ percent during these two quarters, far outpacing the rate of growth of about 4 percent in the economy's potential. Unemployment declined from 1967 levels and averaged 3.6 percent of the civilian labor force. In sharp contrast with 1965-66, the

vigor of expansion was not concentrated in industrial areas. Indeed, industrial production rose at a 5½ percent annual rate during the first half of 1968, less than the pace of real GNP.

## EXPANSION IN THE SECOND HALF

During the final two quarters of 1968, the growth of real GNP was 4½ percent, still above the rate of growth of potential although only by a narrow margin. In current prices, GNP rose \$35 billion (Table 2). The growth in final sales decelerated, and inventory accumulation—after dipping in the third quarter—ended the year at a rate little different from the peak attained in the second quarter.

TABLE 2.—Changes in various measures from the national income and product accounts since second quarter 1967

[Billions of dollars, seasonally adjusted annual rates]

Item	1967 II to 1967 IV	1967 IV to 1968 II	1968 II to 1968 IV <sup>1</sup>
Gross national product.....	30.8	41.9	34.9
Change in business inventories.....	6.0	2.5	— .8
Final sales.....	24.7	39.4	35.7
Personal consumption expenditures.....	11.9	25.7	18.4
Business fixed investment.....	2.3	2.0	7.2
Residential structures.....	5.8	1.0	2.3
Net exports of goods and services.....	—1.7	—1.4	1.0
Government purchases of goods and services:			
Federal.....	3.5	6.5	1.6
State and local.....	2.8	5.6	5.2
Consumer sector:			
Personal income.....	23.6	32.9	30.1
Disposable personal income.....	18.1	26.7	16.2
Personal outlays.....	11.6	26.2	18.8
Personal saving.....	6.4	.6	—2.6
Federal Government sector:			
Receipts.....	8.2	<sup>2</sup> 15.4	15.4
Expenditures.....	7.1	13.3	4.9
Purchases of goods and services:			
National defense.....	2.5	4.4	1.0
Other.....	1.1	2.0	.6
Other expenditures.....	3.6	6.8	3.3
Surplus or deficit (—).....	1.1	2.0	10.6

<sup>1</sup> Preliminary.

<sup>2</sup> Includes \$3.6 billion of retroactive liability from corporate tax surcharge.

Note.—Detail will not necessarily add to totals because of rounding.

Sources: Department of Commerce and Council of Economic Advisers.

In contrast to the first half of the year, the government sector did not propel the advance. Federal purchases of goods and services rose only \$2 billion, and other Federal expenditures increased \$3 billion. Meanwhile, the 10 percent surcharge on corporate and personal income taxes withdrew

over \$10 billion (annual rate) from the private income stream. By the fourth quarter, the Federal budget was essentially in balance.

Both homebuilding and business fixed investment, on the other hand, picked up steam in the second half and ended the year on a particularly strong note. Net exports made a modest recovery. Consumer expenditures advanced \$18½ billion between the second and fourth quarters, much less rapidly than in the first half of the year.

The unemployment rate fell to a 15-year low of 3.4 percent in the fourth quarter, with exceptionally low rates for adult men.

## KEY SECTORS IN 1968

Two components of demand—consumer expenditures and residential construction—were subject to special influences in 1968 and therefore require further examination.

### *Consumer Spending and Saving*

Consumer spending was important in determining the pattern of activity throughout the year. It was particularly stimulative in the third quarter, jumping \$13 billion (annual rate) at a time when the surcharge was first affecting paychecks. Some delay in the adjustment of consumer spending patterns to the marked change in the growth of disposable personal income was expected. A lagged response was apparent, for example, in the behavior of consumption outlays following the tax reductions of 1964–65. The increase in withheld taxes stemming from the 1968 tax surcharge was expected to lead to a similar gradual response of consumption. Some decline in personal saving could be expected to absorb part of the tax for a while.

In fact, saving declined far more than had been anticipated in the third quarter, falling \$7 billion from the second quarter—more than could conceivably be attributed to the \$6 billion of additional taxes from the surcharge. But this was immediately followed by an unusually small rise in consumer spending in the fourth quarter, with a consequent increase in the saving rate. During the second half of the year the saving rate averaged ¾ of a percentage point lower than in the first half—nearly twice the decline that would have been consistent with both an unchanging basic strength of consumer demand and the anticipated lagged response to the tax increase.

The third quarter surge in consumption continued to have a strong impact on economic activity through the end of the year as producers stepped up their rates of production in response to the increases in sales. With production proceeding vigorously, the moderation of consumer spending in the fourth quarter was translated into a substantial accumulation of inventories by yearend.

The marked movements of consumer expenditures during 1968 continued the pattern of late 1966 and 1967. The ratios of consumer purchases

of various categories of goods and services and of consumer saving to disposable personal income for the past several years are shown in Table 3. During the 1959–66 period, consumer spending behavior maintained a fairly consistent relationship to disposable personal income. The saving rates in excess of 7 percent that prevailed in 1967 and the first half of 1968 represented an unusually large fraction of disposable income by comparison with 1959–66, although not with 1956–58. The saving rate has also been subject to substantial quarterly fluctuations about its recent high level.

TABLE 3.—Allocation of disposable personal income in selected periods, 1956–68

Category	[Percent]				
	1956–58 average	1959–66 average	1967	1968	
				First half	Second half <sup>1</sup>
Disposable personal income.....	100.0	100.0	100.0	100.0	100.0
Personal consumption expenditures.....	91.1	91.9	90.1	90.2	91.0
Durable goods.....	12.8	13.3	13.3	13.8	14.2
Autos and parts.....	5.4	5.8	5.6	6.0	6.4
Other durables.....	7.3	7.4	7.7	7.8	7.9
Nondurable goods.....	44.0	41.7	39.5	39.2	39.0
Food and beverages.....	23.9	21.9	20.0	19.8	19.8
Other nondurables.....	20.1	19.8	19.5	19.4	19.2
Services.....	34.3	37.0	37.3	37.3	37.8
Interest paid and transfer payments to foreigners.....	2.1	2.4	2.5	2.4	2.4
Saving.....	6.9	5.7	7.4	7.3	6.6

<sup>1</sup> Preliminary.

Note.—Detail will not necessarily add to totals because of rounding.

Sources: Department of Commerce and Council of Economic Advisers.

There is no clear explanation for the extra saving in the period from late 1966 to mid-1968. But the high saving did contribute to a sharp buildup in consumers' holdings of financial assets and to a slowing in the growth of consumer debt. Together, these developments meant that households had achieved relatively favorable financial positions, which permitted them to increase expenditures markedly whenever they chose to do so. Why they happened to pick the third quarter of 1968 to exercise this option cannot be adequately explained.

### *Residential Construction*

As was the case in the preceding 2 years, monetary policy again had a significant impact on homebuilding activity in 1968. After rising sharply in the second half of 1967, outlays for residential construction remained essentially flat over the first 3 quarters of 1968, despite the fact that household formation and other factors were creating a tremendous underlying demand

for new houses. Only in the fourth quarter did such outlays show an appreciable rise.

The factor that limited homebuilding was a curtailment in the availability of mortgage credit. The net flow of funds into mortgages fell by about 5 percent between the fourth quarter of 1967 and the second quarter of 1968. To some extent this reflected a slowdown of deposit inflows to major mortgage lenders as savers were attracted by the high interest rates available in the open market. But there was also a marked shift away from mortgage lending by mutual savings banks, which invested heavily in high-yielding corporate bonds.

The effects of tight credit on residential construction were, however, far less severe in 1968 than during the 1966 credit squeeze and were also less than most observers had expected. Indeed, the number of new housing units started was at a depressed level in only 2 months—May and June—and then showed unexpected strength during the second half of the year.

In part, of course, the stronger performance of homebuilding in 1968 reflected the fact that credit tightening early in the year was only short-lived and occurred against a background of continued hope for relief with the enactment of the tax surcharge. Builders and mortgage lenders thus tended to stretch a bit to keep operations going.

Steps taken over the past few years to improve the mortgage market also helped to mitigate the effects of tight credit on homebuilding. As a result of 1966 legislation providing for improved coordination of the administrative ceilings applicable to interest rates that thrift institutions may pay on time and savings deposits, the severe competition among the various institutions for each other's deposits that occurred in 1966 was not repeated in 1968. Legislation passed in May 1968 suspended the statutory 6 percent interest ceiling on federally insured mortgages until October 1969, replacing it in the meantime with an administrative ceiling controlled by the Secretary of Housing and Urban Development. This administrative ceiling was raised to 6¾ percent, thereby increasing the availability of these types of mortgages. The legislation of May 1968 also provided for the appointment of a Commission to reexamine the interest rate ceiling and make recommendations for a permanent solution to the problem.

There were also two important reforms affecting the operation of the Federal National Mortgage Association (FNMA) in 1968 that enabled it to support the mortgage market more effectively than in the past. In May, FNMA began auctioning commitments to purchase mortgages in the future, which builders and others could exercise at their option. By the year end, outstanding commitments under this program totaled \$1.2 billion, bringing FNMA's total net participation in the mortgage market during the year to a record \$4.2 billion.

This increased volume of operations was in part due to the other reform, provided for in the 1968 Housing Act, which split the old FNMA into two corporations, one private (still designated FNMA) and the other a new

Government enterprise, the Government National Mortgage Association (GNMA). FNMA, which conducts the auctions mentioned above, has repaid the Government's investment, and its operations have accordingly been removed from the Federal budget. It is now free of the budgetary constraints that had sometimes limited the role of the old Government enterprise in the mortgage market. GNMA has powers—thus far unused—to help private lenders tap the capital market for additional funds that can flow into mortgages.

## RETROSPECT

In retrospect, 1968 is seen as a year of excessively rapid expansion throughout. Yet, there was a noticeable difference between the pace of advance in the first half of the year and that in the second half. The growth rate of real GNP slowed markedly from 6½ percent early in the year to 4 percent by yearend.

Still, a much more pronounced change of pace in activity was expected as well as desired. As of midyear, many Government and private economists expected that the advance of GNP in the second half of the year might be roughly half of the \$42 billion gain for the first 2 quarters. The enactment of the fiscal program was one—but only one—of the elements underlying that expectation. Most of the slowdown was expected to result from a lessening of demand in the private sector—steel and other inventories and homebuilding.

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

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

## WAGES AND PRICES IN 1968

As the economy resumed its vigorous advance in the last half of 1967, inflationary pressures reasserted themselves strongly and continued throughout 1968.

## WAGES AND COMPENSATION

Spurred by rising living costs and growing tightness in many labor markets, both union and nonunion wages turned up sharply. Average hourly earnings of production workers in private nonagricultural establishments rose 7 percent between December 1967 and December 1968, compared with 5 percent in the preceding 12 months. The hourly wage increases during the year for construction, manufacturing, and wholesale trade were all of about the same magnitude, while those in mining and retail trade were somewhat larger.

Average hourly compensation in the private sector, including fringe benefits and employers' social security contributions, rose 7.4 percent from 1967 to 1968—as compared with 6.1 percent from 1966 to 1967 (Table 4).

TABLE 4.—Changes in compensation, productivity, unit labor cost, and output price in the private economy since 1947

Sector and item	Percentage change per year		
	1947 to 1966	1966 to 1967	1967 to 1968 <sup>1</sup>
<b>Total private economy:</b>			
Average hourly compensation: <sup>2</sup>			
Current prices.....	5.2	6.1	7.4
Constant prices <sup>3</sup> .....	3.1	3.2	3.3
Output per man-hour.....	3.5	1.6	3.3
Unit labor cost.....	1.7	4.4	3.9
Implicit GNP price deflator.....	2.0	3.1	3.6
<b>Private nonfarm:</b>			
Average hourly compensation: <sup>2</sup>			
Current prices.....	4.9	6.0	7.2
Constant prices <sup>3</sup> .....	2.8	3.1	3.2
Output per man-hour.....	2.9	1.1	3.4
Unit labor cost.....	1.9	4.8	3.7
Implicit GNP price deflator.....	2.2	3.5	3.6
<b>Manufacturing:</b>			
Average hourly compensation: <sup>2</sup>			
Current prices.....	5.1	5.3	7.0
Constant prices <sup>3</sup> .....	3.0	2.4	3.0
Output per man-hour.....	3.2	.6	2.8
Unit labor cost.....	1.8	4.7	4.2
Implicit GNP price deflator.....	2.0	2.6	(4)

<sup>1</sup> Preliminary.

<sup>2</sup> Wages and salaries of all employees and supplements to wages and salaries such as employer contributions for social insurance and for private pension, health, unemployment, and welfare funds, compensation for injuries, pay of the military reserve, etc. Also includes an estimate of wages, salaries, and supplemental payment part of the income of the self-employed.

<sup>3</sup> Adjusted for changes in the consumer price index.

<sup>4</sup> Not available.

Note.—Data for each sector relate to all persons.

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

Wage increases negotiated in all important collective bargaining situations covered five million workers—an unusually large number—in 1968. Multiyear settlements, covering 5,000 or more workers, had a median increase of 6.6 percent a year in wages and benefits weighted over the life of the contract (Table 5).

In most cases, settlements were heavily “front loaded”—that is, a disproportionate share of the increase was concentrated in the first year. The

average first-year wage settlement was 7.5 percent, substantially above the 5.6 percent increase in 1967. This front-loading of new contracts may contribute to a substantial acceleration of economy-wide wage increases during periods of concentrated collective bargaining activity.

Many of the 1968 settlements replaced contracts negotiated in 1965 or 1966, which had yielded very little gain in real hourly earnings because of the accelerating advance in prices. The unions naturally sought to restore their relative positions as quickly as possible, and hence insisted on concentrating a substantial part of the gains under new contracts in the first year.

TABLE 5.—*Wage and benefit changes in collective bargaining situations, 1963–68*

Type of change	Median percentage change negotiated or effective during					
	1963	1964	1965	1966	1967	1968 <sup>1</sup>
<b>Most important collective bargaining situations, annual rate of increase over life of contract:<sup>2</sup></b>						
Wage and benefit changes negotiated during specified year: <sup>3</sup>						
Equal timing <sup>4</sup> .....		3.5	3.3	4.1	5.2	6.0
Actual timing <sup>5</sup> .....				4.5	5.6	6.6
Wage changes negotiated during specified year: <sup>6</sup>						
Equal timing.....	2.5	3.0	3.3	3.9	5.0	5.1
<b>All important collective bargaining situations:<sup>7</sup></b>						
First-year wage adjustment negotiated during specified year:						
All industries.....	3.0	3.2	3.8	4.8	5.6	7.5
Manufacturing.....	2.5	2.0	4.0	4.2	6.4	7.1
Nonmanufacturing.....	3.4	3.6	3.7	5.0	5.0	7.5
Wage adjustment effective during specified year, regardless of date of negotiations: <sup>8</sup>						
All industries.....	2.9	2.7	3.4	3.6	4.4	5.5
Manufacturing.....	2.7	2.0	3.4	3.3	4.0	5.0
Nonmanufacturing.....	3.2	3.5	3.4	3.8	4.8	6.0

<sup>1</sup> Based on preliminary data available in early January 1969.

<sup>2</sup> Possible increases in wages resulting from cost-of-living escalator adjustments are omitted except for any part of the escalator increase guaranteed in the contract.

<sup>3</sup> The 1964 estimate is based on 20 key contracts which affected 2.25 million workers in 11 major industries. The 1965 estimate covers most settlements affecting 10,000 workers or more in all industries excluding construction, services, finance, and government. Subsequent estimates cover all settlements affecting 5,000 workers or more in all industries except government.

<sup>4</sup> Annual rate of increase assuming equal spacing of wage and benefit changes over life of contract.

<sup>5</sup> Annual rate of increase taking account of actual effective dates of wage and benefit changes during contract period.

<sup>6</sup> The estimates for 1963 to 1965 cover most settlements affecting 10,000 workers or more in all industries excluding construction, services, finance, and government. Subsequent estimates cover all settlements affecting 5,000 workers or more in all industries except government.

<sup>7</sup> All contracts affecting 1,000 or more workers. From 1963 to 1965, construction, services, finance, and government are excluded. All industries except government are covered in subsequent estimates.

<sup>8</sup> Includes changes in wage rates negotiated during specified year, plus increases decided upon in earlier years, cost-of-living escalator adjustments, and no wage changes.

Source: Department of Labor.

## REAL EARNINGS AND UNIT LABOR COSTS

The acceleration of money wages in 1968 was nearly matched by the acceleration of consumer prices so that the increase of 3.3 percent in real hourly compensation in the private economy was only slightly greater than the 1967 increase of 3.2 percent (Table 4).

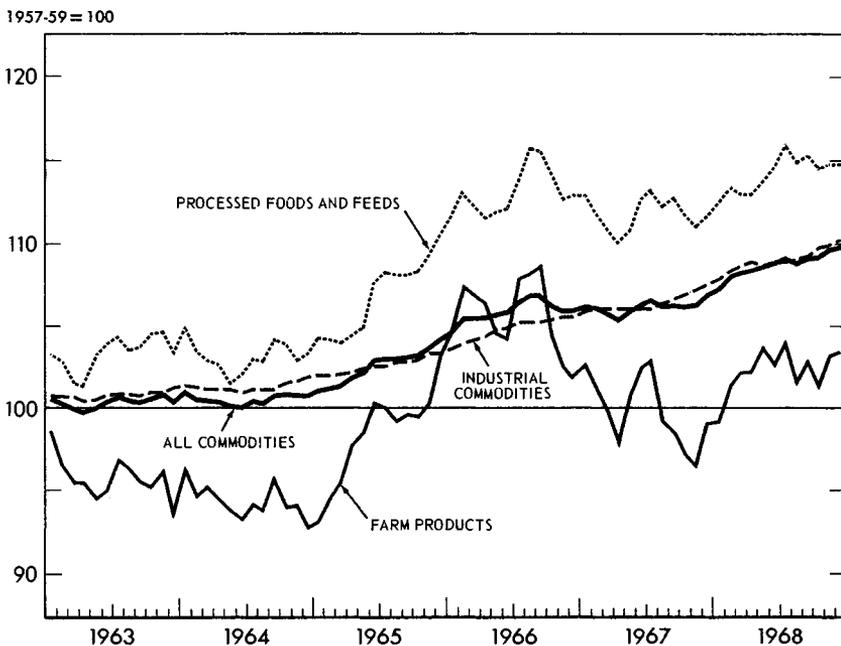
Output per manhour in the private economy rose 3.3 percent in 1968, and this helped offset part of the cost to employers of the increase in hourly compensation. Nevertheless, unit labor costs still rose by 3.9 percent between 1967 and 1968.

## PRICES IN 1968

The general price level advanced sharply in 1968. Wholesale prices increased 2.8 percent in the 12 months ended December 1968, compared with only 0.8 percent during 1967 (Chart 2). Part of the spurt reflected the fact that farm prices rose 4.4 percent during 1968, reversing their decline during the 2 preceding years. However, industrial prices also rose on a broad front, advancing 2.6 percent during 1968 compared with 1.8 percent during 1967.

Chart 2

### Wholesale Prices

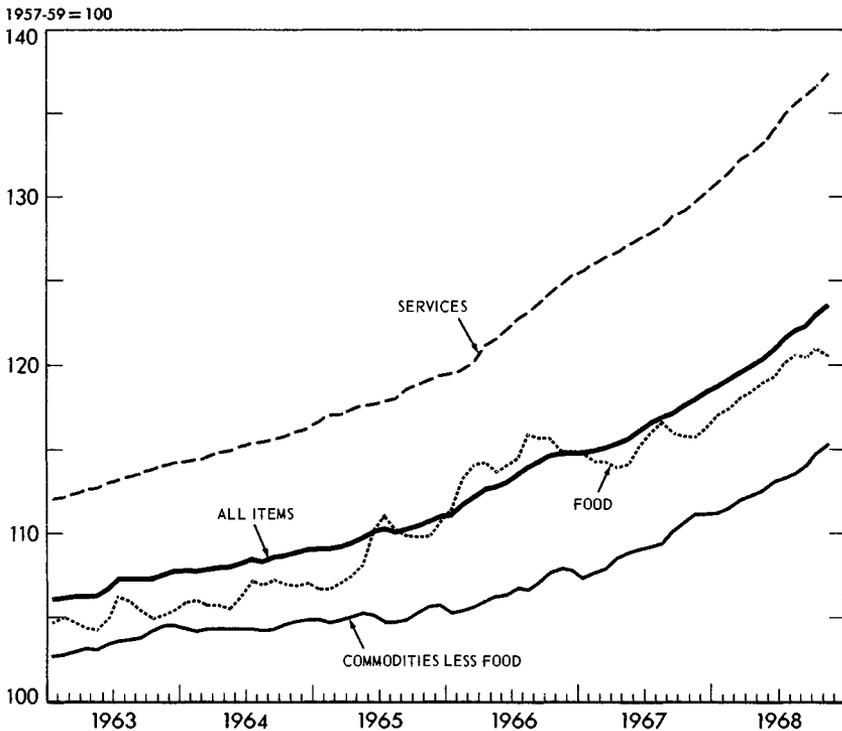


SOURCE: DEPARTMENT OF LABOR.

The consumer price index rose at an annual rate of 4.8 percent during the first 11 months of 1968 (Chart 3). This increase was led by a rise of 6.1 percent in consumer services, including a 7.2 percent jump in the cost of medical services. But prices of consumer commodities also moved up strongly. Partly because mortgage interest and homebuying costs rose particularly sharply, the deflator for personal consumption expenditures in the

Chart 3

## Consumer Prices



SOURCE: DEPARTMENT OF LABOR.

GNP—which excludes these elements—increased considerably less rapidly than the consumer price index. It rose by 3.8 percent during the 4 quarters of 1968.

The behavior of prices in 1968 represented a further intensification of the upward pressures that developed late in 1967. After rising 3.3 percent during 1966, consumer prices slowed to a 2½ percent annual rate of increase during the first half of 1967, when economic activity moderated. But, with the resurgence of over-all demand—spurred by fiscal stimulus—late in 1967, the rate of price increase again accelerated.

### BALANCE OF PAYMENTS IN 1968

Although excessive economic growth generated a surge in imports and a sharp deterioration in the trade surplus in 1968, the overall balance of payments improved markedly. This primarily reflected a dramatic shift in the direction of capital flows. In 1967, the U.S. balance of payments as measured on the liquidity basis registered a deficit of \$3.6 billion; the deficit was reduced to \$1.1 billion at an annual rate during the first 3 quarters of 1968. (Table 6 and Chart 4). For the full year, preliminary estimates

TABLE 6.—United States balance of payments, 1963–68

[Billions of dollars]

Type of transaction	1963	1964	1965	1966	1967	1968, first 3 quarters <sup>1</sup>
Balance on goods and services.....	5.8	8.4	6.9	5.1	4.8	2.4
Balance on merchandise trade.....	5.1	6.6	4.7	3.6	3.5	.4
Balance on investment income.....	3.3	3.9	4.2	4.2	4.6	4.9
Balance on other services.....	-2.6	-2.2	-2.0	-2.7	-3.3	-2.9
Remittances and pensions.....	-.9	-.9	-1.0	-1.0	-1.3	-1.1
Government grants and capital, net.....	-3.6	-3.6	-3.4	-3.4	-4.2	-4.3
U.S. private capital, net.....	-4.5	-6.6	-3.8	-4.3	-5.5	-5.2
Direct investment.....	-2.0	-2.3	-3.5	-3.6	-3.0	-3.3
U.S. bank claims.....	-1.5	-2.5	.1	.3	-.5	.4
Other U.S. private capital <sup>2</sup> .....	-.9	-1.8	-.4	-.9	-2.0	-2.3
Foreign private capital, net.....	1.3	1.9	.3	4.2	3.4	10.4
U.S. securities (excluding Treasury issues).....	.3	-.1	-.4	.9	1.0	3.7
Foreign private liquid capital, net <sup>3</sup> .....	.6	1.6	.1	2.4	1.5	5.4
Other foreign private capital <sup>4</sup> .....	.4	.5	.5	.9	.9	1.3
Errors and omissions.....	-.2	-.9	-.3	-.2	-.5	-.3
<b>BALANCE ON OFFICIAL RESERVE TRANSACTIONS BASIS.....</b>	<b>-2.0</b>	<b>-1.6</b>	<b>-1.3</b>	<b>.3</b>	<b>-3.4</b>	<b>1.9</b>
Plus: Increases in nonliquid liabilities to foreign monetary authorities.....	( <sup>5</sup> )	.3	.1	.8	1.3	2.4
Less: Foreign private liquid capital, net <sup>3</sup> .....	.6	1.6	.1	2.4	1.5	5.4
<b>BALANCE ON LIQUIDITY BASIS.....</b>	<b>-2.7</b>	<b>-2.8</b>	<b>-1.3</b>	<b>-1.4</b>	<b>-3.6</b>	<b>-1.1</b>

<sup>1</sup> Average of the first 3 quarters at seasonally adjusted annual rates.<sup>2</sup> Includes redemptions of foreign securities.<sup>3</sup> Includes changes in Treasury liabilities to international nonmonetary institutions.<sup>4</sup> Includes certain Government transactions associated with special transactions.<sup>5</sup> Less than \$50 million.

Note.—Detail will not necessarily add to totals because of rounding.

Source: Department of Commerce.

show a liquidity surplus—for the first time since 1957. The balance on the official reserve transactions basis improved dramatically, achieving a surplus of \$1.9 billion during the first 3 quarters of 1968, partly as a result of a marked shift in the holdings of liquid dollar assets abroad from foreign central banks to private investors. Such a shift improves the official settlements measure but does not affect the liquidity balance.

The improvement in the balance of payments can be attributed to the President's program announced on January 1, 1968; to some special factors affecting primarily capital flows; and to the continuation of some longer term trends.

### GOODS AND SERVICES

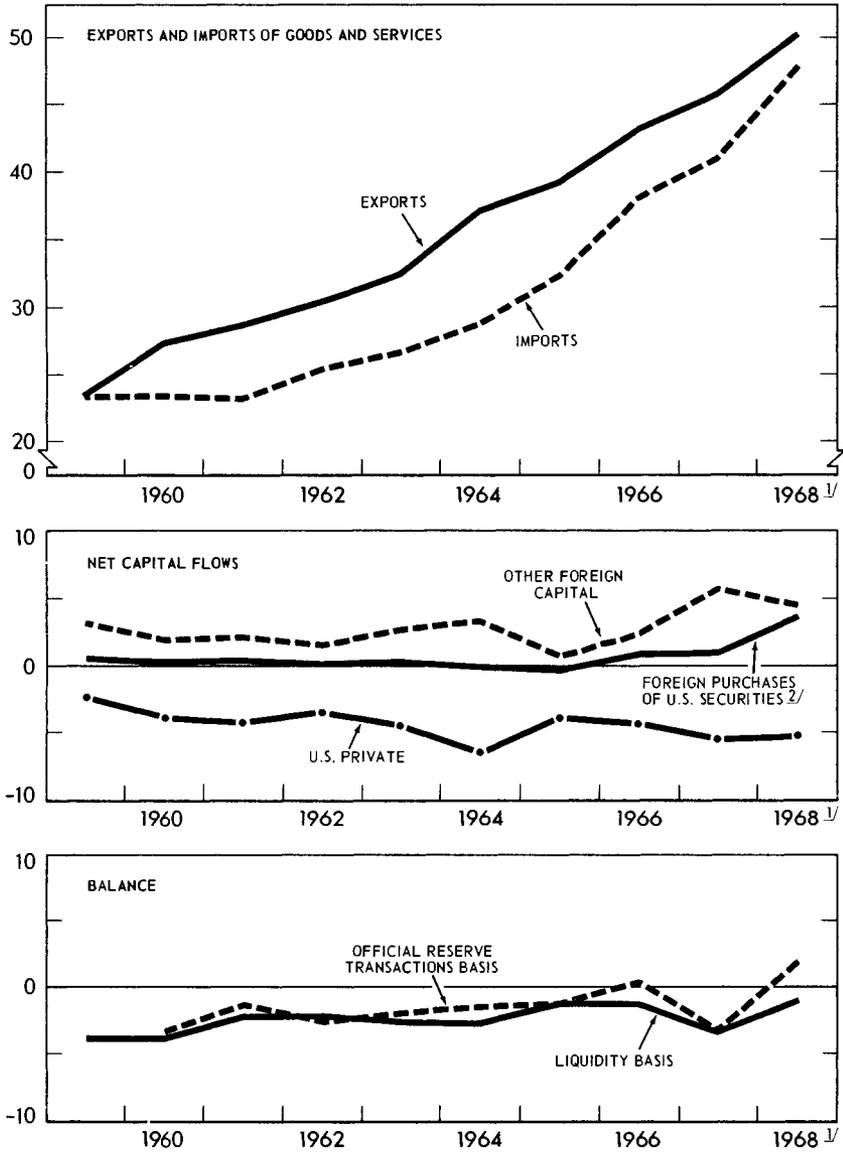
The merchandise trade surplus deteriorated markedly from \$3.5 billion in 1967 to an annual rate of only \$0.4 billion during the first 3 quarters of 1968. Imports rose about 22 percent above 1967. Exports, reflecting mainly the vigorous growth of income abroad, grew by 10 percent.

The U.S. trade balance during 1968 was influenced by strikes in the copper and aluminum industries and a threatened strike in the steel industry,

Chart 4

# U.S. Balance of International Payments

BILLIONS OF DOLLARS



<sup>1</sup>FIRST 3 QUARTERS AT SEASONALLY ADJUSTED ANNUAL RATES.

<sup>2</sup>SECURITIES OTHER THAN TREASURY ISSUES.

SOURCE: DEPARTMENT OF COMMERCE.

all of which stimulated metal imports and reduced the trade surplus by perhaps \$600 million.

Nonagricultural goods accounted for the entire growth of merchandise exports during 1968, with exports to Western Europe and Latin America expanding especially rapidly. Agricultural exports, the most rapidly growing category between 1960 and 1966, declined rather abruptly in 1967 and remained depressed in 1968. While this decline was partially the result of a reduction of sales and donations to less developed countries, it also reflected a sharp decline in commercial exports to the European Economic Community, greatly influenced by EEC restrictions on agricultural imports.

The service account in the balance of payments improved, reaching a surplus of \$2.0 billion annual rate (during the first 3 quarters of 1968), as compared to \$1.3 billion in 1967 (Table 6). The major gain came in net income from foreign investments, which continued its upward trend. Some improvement also occurred in the travel account in 1968, reflecting the reduced attractiveness of the Canadian exposition.

### CAPITAL ACCOUNT

The capital account improved markedly, swinging from a net outflow on private account of \$2.2 billion in 1967 to a net inflow of \$5.2 billion in 1968 (first 3 quarters at annual rate). The new balance-of-payments programs had their major impact on the capital account. Mandatory controls on foreign direct investment, imposed January 1, 1968, greatly stimulated efforts by American firms to raise money abroad. During the first 9 months of 1968, \$1.6 billion of new U.S. corporate securities were sold abroad to finance foreign investments, compared with less than \$500 million during all of 1967. Firms also borrowed other funds totaling \$0.7 billion, about twice the total for 1967. These borrowings permitted direct investment abroad to increase slightly, apparently proceeding in accordance with original intentions. Thus the target of \$1 billion of balance-of-payments savings from the controls over direct investment was achieved without reducing American participation in the economies of other countries.

Operating under new directives issued by the Federal Reserve Board, American banks reduced their claims on foreigners by \$300 million during the first 9 months of 1968, compared with an increase of about \$500 million during 1967. The swing of \$800 million in bank lending exceeded the target of \$500 million set in the January program.

There were other improvements in the capital account that were not directly related to the balance-of-payments program. By the end of September, foreigners had already purchased \$1.2 billion (net) of American securities in the open market (in addition to the \$1.6 billion of new issues previously mentioned). In all of 1967, foreign purchases in the market amounted to only \$0.6 billion, as a \$450 million liquidation of holdings by the United Kingdom held down the total. The greater foreign interest in U.S. stocks and bonds during 1968 can be attributed to rising prices of U.S. equities and

high yields on U.S. bonds, as well as to political developments in France and Czechoslovakia that made European securities seem less attractive. Moreover, long-term forces continued to work, including the basic strength of the U.S. economy, the growing affluence of other countries, and the shortage of foreign corporate securities.

A major inflow of liquid funds resulted from borrowings by American banks from their foreign branches. During 1968, these borrowings increased by \$1.8 billion, compared with only \$200 million in 1967. The major causes of this increase were the existence of relatively tight monetary conditions in the United States and fears about the stability of some European currencies. American banks also seem to be strengthening their ties to the European money market, giving them access to additional sources of funds.

The U.S. Government increased its special financing arrangements during the year. In part, this increase resulted from greater efforts to obtain military offsets or neutralizations in line with the President's program. Some portion also resulted from a bilateral agreement with Canada whereby that country was exempted from the mandatory controls on direct investment.

## ECONOMIC POLICY FOR 1969

Although economic expansion is expected to moderate during the first half of 1969, a continuing policy of restraint is essential to curb inflationary pressures and to strengthen our international trade performance.

### ANTI-INFLATIONARY STRATEGY

Checking inflationary forces that are deeply embedded in the structure of costs and prices is an extremely difficult and delicate process. One approach would be to adopt a drastically deflationary fiscal and monetary policy, involving a sharp reduction in Federal expenditures or a further increase in tax rates reinforced by extreme credit restraint.

Such a policy could surely stop inflation in a reasonable period of time. But the cost would be intolerable—unemployment would rise substantially, and the United States could easily experience its first recession in nearly a decade. As the over-all unemployment rate rose, the rates for the disadvantaged—including nonwhites and teenagers—would rise even more rapidly. With heavy unemployment even among experienced workers, it would be extremely difficult to sustain recent initiatives to provide training and jobs for the unskilled and the disadvantaged. The danger of serious social unrest would be greatly increased. Moreover, the entire economy would suffer a huge loss of output, at a time when full production of goods and services is urgently needed to fulfill national goals.

In any case, halting the current wage-price spiral is only the first step in the longer term task of maintaining reasonable price stability. Once a stable price performance had been achieved through a drastic policy of deflation, a decision would be required concerning the next step. If that choice should

be to prolong the slack performance of the economy, it would extend inequity and waste for years to come. If, on the other hand, there was a decision to shift to expansionary policy, there is no reason to believe that the period of deliberate deflation would have contributed to the longer run solution of the problem. Indeed, a rapid recovery to the economy's potential would probably involve more serious dangers of inflation than would a steadier movement that remained close to the path of potential output.

In view of the intolerable costs of a drastic deflationary policy, a more moderate approach is required. The aim should be to slow down the growth of demand to a rate less than the growth of capacity while consistently maintaining forward motion.

Once the rate of price increase has moderated, fiscal and monetary policy can be gradually adjusted toward stronger expansion. How soon that will prove appropriate cannot be foretold now. Nor can the proper target for utilization in the longer run be stated with assurance. If fiscal-monetary policy can succeed in avoiding spurts of expansion such as those experienced in 1965-66 and again in 1967-68, it should be possible to improve somewhat upon our recent price performance. But it is doubtful whether acceptable levels of unemployment and reasonable price stability can both be achieved without the successful implementation of structural anti-inflationary measures and of voluntary cooperation in wage and price decisions, along lines suggested in Chapter 3. In any case, it is clear that, for 1969, stabilization policy should be designed to hold the rate of expansion of real output below 4 percent but to keep it on a distinctly rising path.

#### **FISCAL PROGRAM FOR 1969**

The President's Budget is designed to fulfill these objectives for economic activity in 1969.

Federal expenditures are expected to rise by about \$10 billion in 1969 compared with an increase of \$19 billion in 1968. Defense purchases are expected to increase by about \$2 billion, while nondefense purchases are scheduled to rise by about \$1 billion. About half of these increases for the full year are accounted for by a pay increase at midyear for Federal civilian employees and the Armed Forces. This increase is designed to make Federal civilian pay scales comparable with those in private industry.

Increases of \$3 billion and \$4 billion, respectively, are anticipated in Federal grants-in-aid to State and local governments and in domestic transfer payments. Most of the increases are either required by existing legislation or designed to help solve problems of highest national priority.

To preserve the needed posture of fiscal restraint in the face of these minimal necessary increases in Federal expenditures, the President is asking the Congress to extend the 10 percent tax surcharge on personal and corporate income for 1 year beyond its present expiration date of June 30, 1969. In addition, the President is requesting a further extension at present levels of

the excise taxes on automobiles and telephone service which are now scheduled to decline on January 1, 1970. With these tax actions, it is estimated that the Federal budget (national income accounts basis) will show a surplus of about \$5 billion during calendar 1969, compared with a deficit of \$5 billion in 1968.

The 10 percent tax surcharge was enacted as a temporary measure in June 1968 and is to be extended for 1 year as a temporary measure. Indeed, the President is urging the new Administration and the Congress to give serious consideration to coupling the extension of the surcharge with authority for the President to remove it entirely or partially, subject to Congressional veto, if warranted by developments in Vietnam, in the domestic economy, or in Federal outlays.

## MONETARY POLICY

Monetary policy should remain flexible in 1969. In the environment prevailing at the start of the year, it is appropriate that monetary policy reinforce the effects of fiscal restraint to assure the needed moderation of pressures on the Nation's resources. The recent increase in the Federal Reserve discount rate and increased pressures on bank reserve positions are pursuing that objective. A slowing from the recent rapid growth of bank credit is appropriate in early 1969.

But with fiscal restraint continuing through fiscal year 1970, monetary policy may gradually be able to shift to a less restrictive stance than presently prevails. Flexible and alert responses to a moderation of economic activity would permit a timely de-escalation of interest rates from their currently high levels and hence a more adequate flow of funds to savings institutions and the mortgage market.

A decline from present peak levels of nominal interest rates would be desirable for the long run as well to avoid restricting capital formation and economic growth in general, and homebuilding in particular. The continuation of the surcharge through fiscal 1970 should permit a gradual movement toward a more desirable mix of monetary and fiscal policies; with fiscal policy better adjusted to the needs of economic stabilization, the need for restrictive monetary policy and relatively high interest rates should gradually abate.

## ECONOMIC OUTLOOK FOR 1969

The fiscal restraint contained in the Revenue and Expenditure Control Act of 1968 will have its major impact on the economy early in 1969. Assuming the fiscal program outlined above and appropriate monetary policy, GNP is expected to rise by \$60 billion in 1969 from the \$861 billion now estimated for 1968. This projection should not be viewed as an exact estimate, but rather as the midpoint of a range of possible outcomes.

This forecast of an increase of approximately 7 percent in GNP means a continuation of prosperous conditions and economic expansion, though, as

desired, at a considerably more moderate rate than in 1968. The unemployment rate should remain below 4 percent.

The expansion within 1969 is expected to be considerably less rapid than during 1968, and the increase in GNP from the fourth quarter of 1968 to the fourth quarter of 1969 should be about 6 percent—smaller than the year-over-year increase. The rise in real output during the four quarters of 1969 should be less than 3 percent while the rate of increase of over-all prices may be a little more than 3 percent.

The first part of 1969 should see a slowing of economic expansion. Consumer spending should rise moderately, influenced by the continuing impact of tax withholding, extra final settlements of about \$1½ billion on 1968 taxes, and a \$3 billion increase in social security taxes which became effective January 1. Federal Government purchases will change little while State and local government expenditures are expected to increase at a normal pace. Inventory investment should retreat from the high rate of the fourth quarter of 1968. On the other hand, a strong rise in business fixed investment is expected early in 1969, in line with recent surveys of business plans and new orders for machinery and equipment. All in all, a significant slowing in the pace of expansion is now likely.

At mid-1969, a substantial pay increase for Federal Government employees is scheduled. Beyond that, only a slight increase in Federal purchases is anticipated. The tax burden on consumers will also be reduced at that time as final settlements on 1968 taxes are completed in the first half of the year, although consumer spending should continue to feel the lagged effects of the final settlements. These fiscal elements, together with a continuing increase in private investment, are expected to lead to slightly more rapid economic expansion in the second half of the year.

Thus the year 1969 promises continued prosperity for the American economy. The slowing of the expansion should provide welcome relief from the excessive demand pressures of 1968 and offers the prospect of some deceleration in the upward movement of prices.

## OUTLOOK BY SECTORS

A brief survey of the outlook for specific categories of expenditures will help to clarify the projection of over-all economic activity.

### *Business Fixed Investment*

Private and public investment surveys compiled recently indicate a substantial rise in business fixed investment in 1969. The Commerce Department-SEC survey reports that businessmen plan to increase their plant and equipment spending by about 9 percent in the first half of 1969 above levels prevailing in 1968. Such a sharp increase in investment is already reflected in orders for durable equipment and in construction contracts. This marked prospective expansion of investment follows a year when industrial production has reached new peaks and when business cash flows

have been at record levels, but when there has been relatively little pressure on existing industrial capacity. The dimensions of the rise in investment are still difficult to evaluate in view of uncertainty about the possible impact of economic developments during the first half of the year and of monetary policy on business plans later in 1969. For the year as a whole, the increase in business fixed investment over 1968 is expected to be about \$7 or \$8 billion.

### *Inventories*

At the end of 1968, ratios of inventories to sales were at normal levels, both for manufacturing and for retail and wholesale trade. Barring unforeseen changes in economic conditions over the year, inventory investment in 1969 may show a slight decline from the average rate of 1968.

### *Homebuilding*

Demographic trends and the relatively low level of residential construction in recent years have created a very strong underlying demand for new homes. Housing starts rose sharply in the second half of 1968, and residential construction activity should advance further early in 1969. Because of the important role in the housing market of the availability of mortgage financing, considerable uncertainty attaches to estimates of home construction beyond the next few months. Given the prospective monetary policy for this year as outlined above, private nonfarm housing starts in 1969 may be expected to fall somewhat below their recent rate of approximately 1.6 million per year. Residential construction expenditures for the year may rise by approximately 10 percent over the average 1968 level, reflecting a larger number of new housing units and increased outlays per unit. But this would mean only a modest rise from the rate of activity at the end of 1968.

### *Government*

For the year 1969 an increase of State and local government purchases of goods and services of about \$10 billion can be anticipated in line with the growing needs for public services and facilities. This estimate assumes that monetary policy will not significantly curtail expenditures for public construction projects.

Federal Government purchases are expected to remain at approximately their present levels during the first half of 1969, in accordance with expenditure restraint applied under the Revenue and Expenditure Control Act of 1968. However, an increase in Federal Government salaries will add \$2.8 billion at annual rates to Federal Government expenditures beginning in the third quarter of 1969, and the Budget for fiscal 1970 in-

cludes other modest increases in purchases. For the calendar year 1969, Federal purchases of goods and services, including the pay increase, are expected to be approximately \$3 billion higher than in 1968.

### *Consumption*

Consumer spending in 1969 will be greatly influenced by the continuing adjustment of consumers to the changes in their disposable incomes resulting from the pace of advance in private and Government activity and from changes in their tax obligations.

Consumer spending slowed in the closing months of 1968. Retail sales have not increased significantly since midsummer and the pace of automobile purchases has moderated.

In the first half of 1969, increased tax burdens will further slow the growth of disposable personal income, although this may be reflected, in part, in a renewed decline of the saving rate. Consumer expenditures are thus expected to grow rather slowly during the first half of 1969. Surveys of consumer buying anticipations tend to confirm this prospect.

Personal disposable income may grow somewhat more rapidly in the second half of 1969—in part because of the Federal pay increase and the completion by mid-year of final 1968 tax settlements. Thus, consumer spending may advance more strongly.

For the year as a whole, it is anticipated that disposable personal income will increase nearly \$35 billion and consumer expenditures should increase approximately the same amount reflecting a small decline in the saving rate.

### **PRICE OUTLOOK**

The excessive rate of price and wage advance during 1968 will inevitably influence wages, costs, and prices during 1969. Unit labor costs will continue to increase, as will the costs of materials, supplies, and capital equipment. Financial costs are also likely to remain relatively high.

Gradually, however, fiscal restraint coupled with restrictive monetary policy should moderate the excessive market pressures that prevailed during most of 1968. Present indications point to slightly lower farm prices during 1969, assuming normal weather conditions. Allowing for a continued increase in the costs of food processing and distribution, food prices at retail may remain approximately stable.

Wage increases may have somewhat less impact in 1969 than they did in 1968. Second year increases in the union contracts negotiated in 1968 and the last half of 1967 will generally be less than for the first contract year. Collective bargaining activity will also be relatively light, since expiring major contracts up for wage negotiations cover only about half as many workers as in 1968. And finally, as restraint takes hold more firmly, lessened market pressures provide a prospect for some moderation in nonunion wages as well.

## *Wage-Price Policies for 1969*

If substantial progress is to be made toward the restoration of price stability in 1969, restraint in private decisions is essential to complement responsible fiscal and monetary policies. Intensive consultations involving representatives of business, labor, and Government are required to explore practical and equitable ways in which such restraint might be achieved. Mutual short-term sacrifices are needed to protect the great long-term interest of business, labor, and all Americans in noninflationary prosperity.

It would be unrealistic to expect the full restoration of price stability in the immediate future. Given the recent history and the outlook for the cost of living, labor cannot be expected to accept wage increases in 1969 limited to the trend growth of productivity. Nor can businessmen be expected to absorb substantial cost increases without any adjustments in prices.

Nevertheless, the process of price and wage deceleration must begin. In their own and in the public interest, business and labor should undertake a pattern of voluntary restraint that will carry the Nation a substantial distance back toward the goal of price stability in 1969. New wage agreements would move halfway back to the ultimate productivity standard next year if labor accepted wage settlements that would bring the average increase in money wage rates a little below 5 percent. Business would display comparable restraint in pricing if it intensified its efforts to offset rising costs through greater efficiency and if it absorbed a share of unavoidable increases in costs through acceptance of lower profit margins.

This could be translated into a general rule that business agree to absorb increases of up to 1 percent in unit costs and accept as a guide in price decisions a profit target no higher than the average achieved in the years 1967–68. Responsible pricing requires that businessmen focus on margins *before* tax and not attempt to pass the temporary corporate tax surcharge on to consumers. It is also appropriate to ask those who depart from these standards to bear the obligation of demonstrating that special circumstances render the standards grossly unreasonable.

These standards for price-wage restraint in 1969 were suggested by the Cabinet Committee on Price Stability in its December 1968 report to the President.

Combined with responsible fiscal-monetary policy and continued efforts to improve the structure of the economy, acceptance of these standards for 1969 by key private decision-makers would carry the Nation a long way on the road to price stability.

## OUTLOOK FOR THE BALANCE OF PAYMENTS

With the anticipated slowing of economic growth, only a modest increase in imports is expected in 1969. The special strike situations which adversely affected trade in 1968 should not be repeated, although new problems of this kind could arise. Continuation of the rising trend in earnings on foreign

investment should be another source of improvement in our current account position.

U.S. exports should increase in line with the expansion of foreign markets. The restrictive measures taken by France and the United Kingdom to safeguard their payments positions have reduced our export prospects, but these are likely to be offset by the German measures in the opposite direction.

The capital account is unlikely to show improvement, and indeed may deteriorate. The restraint on bank lending cannot provide another large swing in net loans. Foreign purchases of U.S. securities can hardly be expected to continue at present rates. Even more important will be the state of financial markets at home and abroad. If European monetary conditions remain fairly relaxed relative to those prevailing in the United States, capital inflows can be expected—even if not on the same scale as in 1968.

In view of the uncertain prospects for the balance of payments, the measures for controlling capital movements must be maintained for the present. The Interest Equalization Tax which expires at mid-year must be continued to assure against a major rise of new foreign security issues in the United States. Moreover, the program for controlling bank lending and the direct investment controls should be maintained. Both have been modified to make them more responsive to needs and more equitable. While further modifications will be possible as the balance of payments improves, the defenses provided by these programs cannot be lowered without risking the destabilizing effects of substantial refinancing of previous years' borrowings. Ultimate dismantling of the controls should proceed as soon as this can be accomplished without impairing the strength of the dollar.

## Chapter 2

# Policies for Balanced Expansion

*The Congress hereby declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy . . . to promote maximum employment, production, and purchasing power.*

**F**OR THE PAST 23 YEARS, these forthright marching orders in the Employment Act of 1946 have firmly committed the Federal Government to an active role in promoting high standards of over-all economic performance. Federal fiscal and monetary policies have contributed to a much improved record of stability and growth in the U.S. economy throughout the postwar era.

In particular, during the past 8 years, national policy has been designed not merely to counter cyclical fluctuations but to promote steady expansion of economic activity in pace with productive potential. While fiscal and monetary policies have not always been appropriate to the needs of the day, their general success in fulfilling the lofty promises of the Employment Act is clearly demonstrated by the unparalleled prosperity achieved during the Kennedy and Johnson Administrations. Eight consecutive years of economic expansion, the longest and largest sustained advance in the annals of U.S. history, have dispelled the doubts that prevailed in the late 1950's about the vitality of the American economic system.

The lessons of this experience are worth reviewing. Such a review, together with some suggestions for improvements in the formulation and implementation of stabilization policies, is the subject of this chapter.

### REALIZING THE ECONOMY'S POTENTIAL

How much the Nation's economy can produce—its supply capability—depends on the quantity and quality of its productive resources, including manpower, plant and equipment, and natural resources. The economy's aggregate demand is the total of spending for final output by all groups—consumers, businesses, government, and foreign buyers. When aggregate demand matches supply capability, resources are fully utilized and production equals the economy's potential. If aggregate demand should fall short of supply capability, part of the output that the economy is capable of turning out

would not be produced, and some resources would be wasted in idleness. On the other hand, excessive demand—too much spending in relation to potential output—would generate inflationary pressures on prices and costs.

The basic task of fiscal and monetary policies is to help ensure a match between demand and productive potential. These measures operate primarily by affecting the demand side of the balance. Government purchases of goods and services are directly a part of total demand; increases or decreases in such purchases change total spending in the same direction. In addition, other government expenditures indirectly influence total demand through their impact on private incomes. Social security benefits, for example, are “transfer payments” which add to the purchasing power of individuals, and thus encourage additional private spending, especially for consumer goods and services.

Taxes, on the other hand, reduce the ability and willingness of families and business firms to spend, by drawing purchasing power out of private hands. By raising (or lowering) tax rates, the Federal Government can hold down (or add to) the flow of private spending.

Monetary policies affect private spending primarily by changing the cost and availability of funds required to finance certain types of expenditures. If borrowing becomes expensive and difficult, expenditures for new homes, business machinery, and other things may be discouraged or postponed.

The economy’s potential output is continually expanding as a result of the growth of the labor force and increases in productivity. Economic policy must therefore aim at a moving target—helping demand to grow in pace so that an appropriate balance with potential is maintained. If demand does not expand or if it grows only sluggishly, men and machines become unemployed.

#### THE CHOICE OF A TARGET

Economic potential or capacity is not an absolute technical ceiling on output. It allows for some margin of unused human and physical resources. Even in the most extreme boom, there are always some people unemployed, some who could be attracted into the labor force, some who would be willing to “moonlight” or work overtime. Similarly, there are always some plants that could be operated more intensively or for longer hours. To operate the economy at its utmost technical capacity would require demands far in excess of supply in most markets, with resulting rampant inflation.

The relevant concept of capacity, therefore, must allow for some margin of idle resources. The choice of a specific margin involves an appraisal of the behavior of prices and costs in a high-employment economy. But this appraisal involves more than a technical evaluation. If potential output is to be viewed as a target for policy, the choice of the ideal level of utilization is a social judgment that requires a balancing of national goals of high employment and reasonable price stability.

Balances of this sort are never simple. Both unemployment and inflation involve social and individual costs. The severe economic burden borne by those who have no jobs is obvious. At the bottom of the 1957-58 recession, there were more than five million workers out of jobs; and during 1958 more than 14 million workers experienced one or more spells of unemployment. Still others were forced to accept part-time employment or were relegated to jobs beneath their capacity. Some, in resignation, abandoned the search for jobs. The loss of income was tremendous. The costs in frustration, despair, and bitterness cannot be measured.

Some of the costs of unemployment linger on because skills and supplies of labor are impaired. When over-all unemployment is excessive, employers have little incentive to provide job training programs for the unskilled or to upgrade workers to better paying jobs. Labor unions become increasingly concerned about the job security of existing members and often take measures that limit the supply of available labor for the longer run.

Although the burden of a slack economy falls most heavily on the unemployed, the loss of production associated with underutilized resources imposes serious costs on nearly all groups. The incomes lost by the unemployed represent far less than half of the total shortfall of output and income. A slack economy sharply reduces the profits of large and small businesses and cuts government tax revenues. Moreover, part of the burden falls on future generations, because underutilization of capacity weakens investment incentives, slowing the rate of capital accumulation and limiting future productivity gains.

It is difficult to balance the costs of inflation against those of an absolute loss of output and employment, because they are quantitatively and qualitatively different. Inflation has highly arbitrary and inequitable effects on the distribution of income and wealth. It benefits debtors at the expense of creditors; it hurts persons, such as some pensioners, whose incomes and asset values are fixed in money terms, and benefits those whose incomes and asset values increase more than in proportion to the over-all rise in prices. Since the impact of inflation on the welfare of an individual depends on the way in which both his income and the value of his wealth respond to the change in prices, its effects on broad classes of the population cannot be easily characterized. But there are many persons, in nearly all walks of life, who experience significant losses as a result of inflation. In general, financially sophisticated persons, who foresee the consequences of rising prices, can take steps to protect themselves, while the less sophisticated may lose.

There is also a danger that inflation can set in motion speculative behavior that will cause further acceleration of price increases, with serious consequences for economic and social stability. There are even extreme examples in history of the breakdown of financial and economic systems as a result of galloping inflation.

Finally, inflation may have adverse consequences for our balance of payments. If prices rise more rapidly in the United States than in other

countries, our competitive position in world markets can be seriously undermined.

As a collective social decision, the choice of an employment objective can and should be the subject of continuous reexamination. Chapter 3 suggests a number of structural measures that can help to lessen the conflict between high employment and price stability. When combined with an improved performance of fiscal and monetary policy along lines discussed in this chapter, these measures may make it possible to achieve progressively lower rates of unemployment with reasonable price stability.

## POTENTIAL OUTPUT

In light of the considerations discussed above, a 4-percent unemployment rate was established as an "interim" target for national policy early in the Kennedy Administration. In each of its last seven Annual Reports, the Council of Economic Advisers has based its estimates of potential output on a 4-percent rate of unemployment. This Report continues to make use of this definition.

The resulting estimated path of potential output for the period 1955 to 1968, together with the path of actual gross national product (GNP), is shown in Chart 5. Actual GNP was approximately equal to potential in 1955, but fell gradually below potential in the following years. The gap widened sharply in the 1957-58 recession, it failed to close fully in the ensuing expansion, and it widened again in the recession of 1960-61. In the first quarter of 1961, the gap amounted to about \$60 billion (in 1968 prices), and the unemployment rate was 6.8 percent.

From the first quarter of 1961 until the end of 1965, when the unemployment rate reached 4 percent, actual output was consistently below potential. But actual output grew more rapidly than potential, catching up and finally closing the gap. Since then, actual output has exceeded the calculated potential most of the time, as the unemployment rate has been below 4 percent.

It is estimated that potential output grew about 3½ percent a year from the mid-1950's to the early 1960's. After that, its growth appears to have speeded up gradually; for the last few years, it is estimated at 4 percent a year.

Growth of potential output reflects the combined effects of expansion of available man-hours of labor and rising output per man-hour.

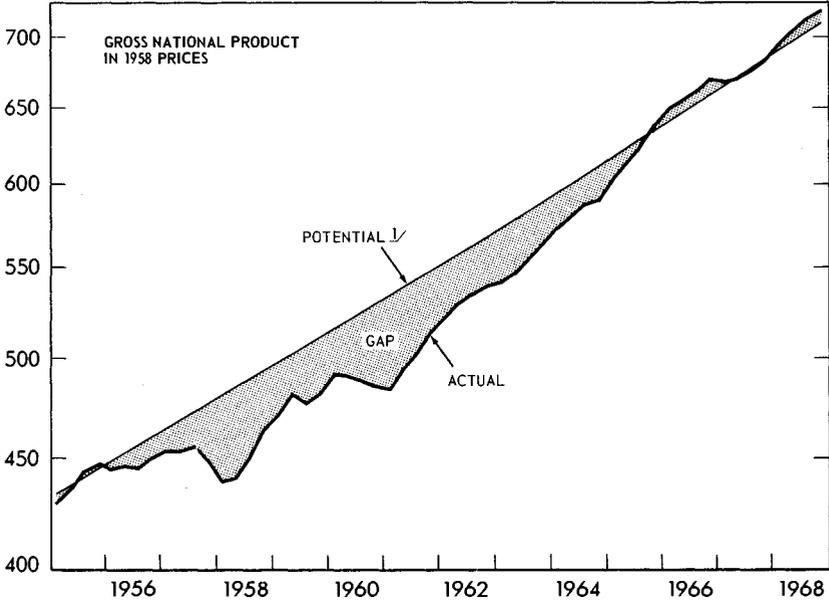
### *Available Man-Hours*

Sustained growth of the labor force has resulted in a substantial rise in potentially available man-hours despite a gradually declining trend in average hours of work. Over the long run, the labor force has increased roughly in line with the working-age population (16 years old and over). This tendency has continued in the 1960's. The rising participation of women in the labor force has been roughly offset by the effects of a shift

Chart 5

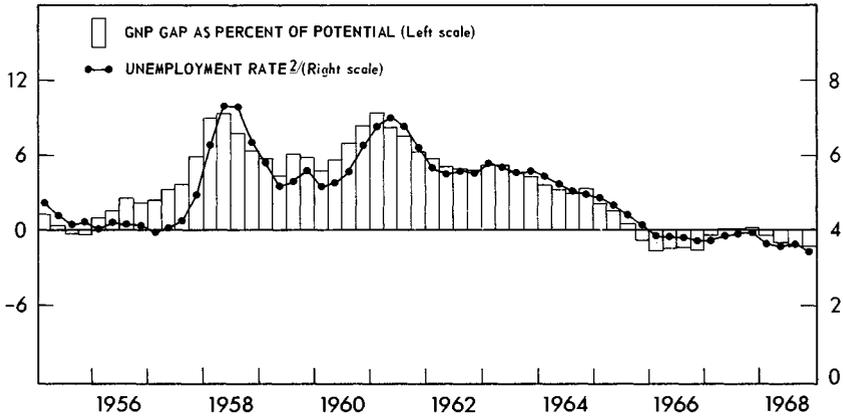
# Gross National Product, Actual and Potential, and Unemployment Rate

BILLIONS OF DOLLARS (ratio scale)\*



PERCENT

PERCENT



\*SEASONALLY ADJUSTED ANNUAL RATES.

1/TREND LINE OF 3% THROUGH MIDDLE OF 1955 TO 1962 IV, 3% FROM 1962 IV TO 1965 IV, AND 4% FROM 1965 IV TO 1968 IV.

2/UNEMPLOYMENT AS PERCENT OF CIVILIAN LABOR FORCE; SEASONALLY ADJUSTED.

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

in the composition of the working-age population toward teenagers and older people, who have relatively low participation rates.

Average hours worked per employed person have declined slowly over the long run, reflecting the secular trend toward more holidays, longer vacations, shortening of the workweek, and increasing participation of people who want to work only part time.

Growth of the potential labor force has accelerated from  $1\frac{1}{4}$  percent a year in the early 1960's to a present rate of about  $1\frac{3}{4}$  percent—reflecting the upsurge in births immediately after World War II. This has been partially offset by the secular decline in hours worked of about  $\frac{1}{4}$  of 1 percent a year. The net result has been an acceleration of the growth of available man-hours from 1 to  $1\frac{1}{2}$  percent a year over the period.

### *Productivity*

Many factors contribute to growth in output per man-hour—the productivity of labor. These include increases in the stock of productive capital and improvements in its quality; better educated, better trained, and more experienced labor; and advances in technology, production methods, and management techniques.

Since 1950, output per man-hour in the private economy has expanded at an average annual rate a little above 3 percent. For the entire economy, the calculated trend is somewhat lower, because improvements in the efficiency of Government workers are not measured statistically and are arbitrarily taken at zero. Thus the trend rate of increase in aggregate productivity—private and public—has been about  $2\frac{1}{2}$  percent a year. When added to the growth of available man-hours, this results in the  $3\frac{1}{2}$  percent annual growth of potential output for the late 1950's and the 4 percent current growth rate.

### *Actual and Potential GNP*

Over the entire period from the recession trough in the first quarter of 1961 to the fourth quarter of 1968, actual GNP rose by \$288 billion (in 1968 prices), reflecting the combined result of keeping up with the growth of potential GNP and of closing the gap. Potential GNP rose by \$216 billion, an increase of 33 percent. Thus the Nation is presently earning a huge additional bonus of \$72 billion a year in output as a result of having eliminated a great waste of idle resources.

The unemployment rate in the first quarter of 1961 stood at 6.8 percent. At current levels of the labor force, the reduction of this rate to the 3.4 percent that prevailed in the fourth quarter of 1968—below the 4 percent rate that is used to define potential output—represents a gain in employment of 2.7 million. On the basis of current average productivity, this number of workers can be credited with a \$31 billion contribution to output (annual rate).

However, the reduction of 3.4 percentage points in the unemployment rate accounts directly for only a portion of the gain in output associated with the closing of the gap. There were four other important factors involved:

1. In a slack economy, firms are often reluctant to lay off certain types of workers, particularly foremen, semi-professionals, and the highly skilled. The result is considerable on-the-job underemployment which depresses measured labor productivity. As the economy moves back toward potential, productivity increases more rapidly than the long-term trend. Since early 1961, output per man-hour has risen at an average annual rate of 3 percent,  $\frac{1}{2}$  of a percentage point more than trend.

2. Labor force participation has risen since 1961 as people who had not been looking for work responded to the greater availability of job opportunities.

3. The increased pace of economic activity slowed the secular decline in the length of the workweek.

4. The proportion of the labor force reporting involuntary part-time employment for economic reasons declined from 4.4 percent in early 1961 to 2.1 percent in the fourth quarter of 1968.

Together, these four factors contributed an additional \$41 billion to the output gain associated with the reduction of the unemployment rate.

The \$72 billion of extra GNP resulting from reducing the unemployment rate amounts to about 11 percent of potential output at the start of the period—that is, there was about a 3 percentage point bonus of annual production for each 1 percentage point reduction in the unemployment rate.

#### ECONOMIC GAINS OF THE EXPANSION

The chief over-all measures of the progress of the American economy during the past 8 years are presented in Table 7. The benefits of economic expansion have permeated nearly every corner of the economy and every aspect of our national life. From the recession trough in early 1961 to the end of 1968, the expansion of output created more than 10½ million jobs. This was enough to provide work for the 8½ million net increase in the labor force while at the same time reducing the pool of unemployed workers by more than two million.

Living standards have substantially increased. On an after-tax basis and after adjusting for price increases, total disposable personal income per capita—the purchasing power of households—has risen by 33 percent since early 1961. Personal consumption expenditures per person have risen in step.

Meanwhile, net financial assets of households—the excess of their financial assets over their debts—have grown from \$700 billion at the end of 1960 to an estimated \$1,350 billion at the end of 1968.

TABLE 7.—Measures of economic activity during the current expansion

Series	Unit or base	Amount		Percentage change <sup>1</sup>	
		1961 I	1968 IV <sup>4</sup>	Total	Per year
<b>Production:</b>					
Gross national product <sup>2</sup> .....	Billions of dollars, 1958 prices. <sup>3</sup>	482.6	719.1	49.0	5.3
Personal consumption expenditures.....	do.....	316.2	454.8	43.8	4.8
Business fixed investment.....	do.....	44.9	79.4	76.8	7.6
Residential structures.....	do.....	20.9	24.0	14.8	1.8
Government purchases.....	do.....	97.6	151.0	54.7	5.8
Federal.....	do.....	52.2	79.4	52.1	5.6
State and local.....	do.....	45.4	71.6	57.7	6.1
Industrial production.....	1957-59=100.....	103.7	167.3	61.3	6.4
<b>Income:</b>					
Disposable personal income.....	Billions of dollars <sup>3</sup> ..	354.8	602.5	69.8	7.1
Corporate profits after tax.....	do.....	24.4	4 51.2	109.8	10.4
Per capita disposable personal income.....	Dollars, 1958 prices <sup>3</sup> ..	1,871	2,483	32.7	3.7
<b>Employment:</b>					
Civilian employment.....	Millions of persons..	65.7	76.4	16.3	2.0
Nonagricultural payroll employment.....	do.....	53.5	68.9	28.8	3.3

<sup>1</sup> Preliminary.

<sup>2</sup> Total includes change in business inventories and net exports of goods and services not shown separately.

<sup>3</sup> Annual rates.

<sup>4</sup> 1968 IV not available; 1968 III used.

Note.—All data are seasonally adjusted.

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

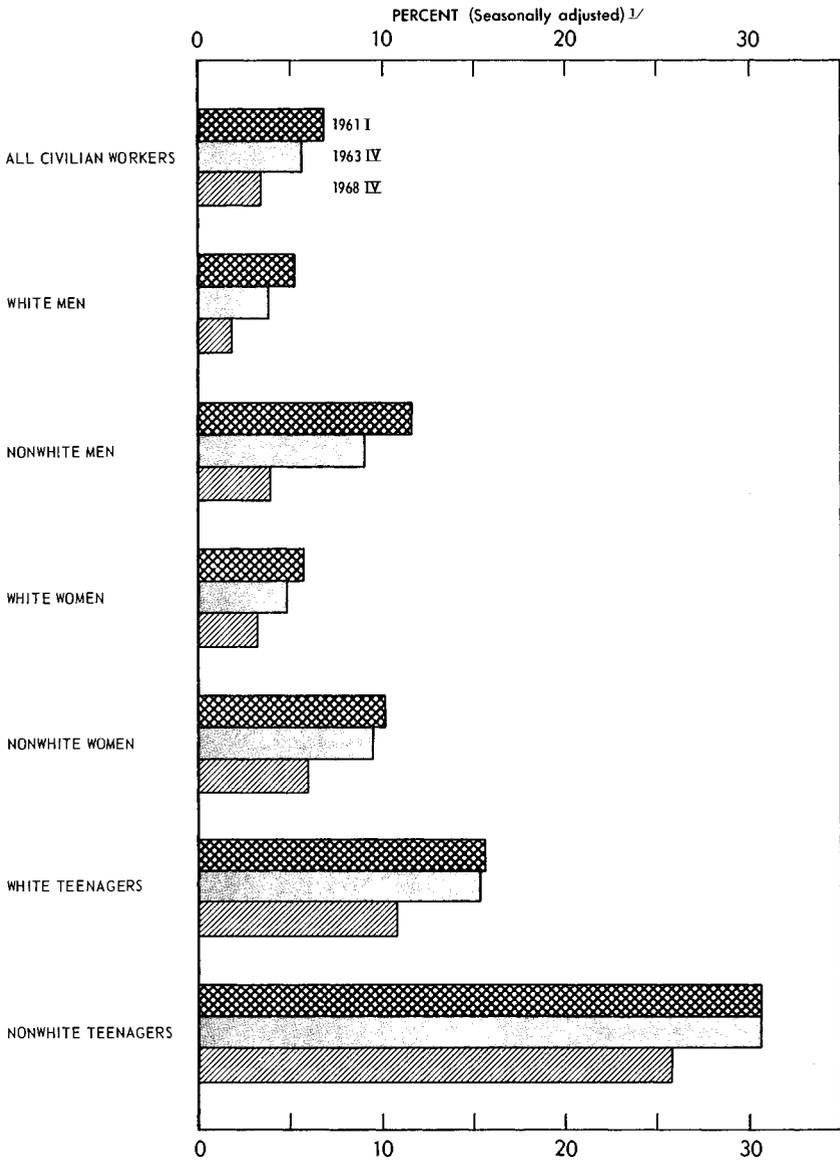
Corporate profits have more than doubled during the past 8 years, both before and after taxes. In addition to permitting sharply increased dividend payments to stockholders, these rising profits have provided the financing for a wholesale expansion and modernization of the Nation's productive capacity. Indeed, business has increased its real stock of capital goods by more than 40 percent since the end of 1960 and has progressively reduced the average age of existing capital.

The decline in the over-all unemployment rate since early 1961 has been accompanied by equally impressive gains by specific categories of the labor force, as shown in Chart 6. In particular, the unemployment rate for white adult males had fallen to 1.8 percent by the fourth quarter of 1968, a level last achieved in 1953. For nonwhite adult males the decline in unemployment has been especially dramatic—from an intolerable 11.6 percent rate in early 1961 to 3.9 percent in late 1968. This represents a significant narrowing of the differential between white and nonwhite unemployment rates for men, from 6.4 percentage points at the beginning of the period to about 2 percentage points by the fourth quarter of 1968. On the other hand, there has been little progress in reducing the unemployment rates of teenagers, especially nonwhites.

The progressive tightening of the over-all labor market during this period has made a substantial contribution to the elimination of employment barriers based on race and sex. While these are significant gains, the unemployment rates for some groups of workers still remain appallingly high. As Chapters 3 and 5 make clear, additional efforts are needed to

Chart 6

# Unemployment Rates



<sup>1/</sup>PERCENT OF CIVILIAN LABOR FORCE IN EACH GROUP WHO ARE UNEMPLOYED.  
SOURCE: DEPARTMENT OF LABOR.

assist such workers, who often suffer from such disadvantages as inadequate training and job discrimination.

The strong advance in the economy has also permitted rapid progress in many social fields. As discussed more fully in Chapter 5, the number of Americans in poverty declined by 18 million during the past 8 years. Rates of infant and maternal mortality have been reduced, school enrollment and school completion rates have been raised, and millions of additional young people have been able to attend college.

Many of these advances would have been impossible to achieve if rising tax revenues had not been generated by a vigorously expanding economy. Federal revenues expanded from \$92½ billion in fiscal 1960 to an estimated \$186 billion in fiscal 1969, while State and local government revenues more than doubled. School construction, urban development, low-income housing, and many other programs at all levels of government have expanded correspondingly.

## THE PROBLEM OF ECONOMIC FLUCTUATIONS

There is nothing inherent in the U.S. economy to ensure that total demand will grow consistently in pace with the economy's productive potential. The sum total of millions of decentralized spending decisions by households, businesses, and governments at all levels will not automatically and necessarily match potential output.

The historical record is marked and marred by a pattern of fluctuations in which the economy often took two steps forward and then one step back. According to the National Bureau of Economic Research, the United States suffered 27 business-cycle contractions between 1854 and 1961, an average of one every 4 years. At other times, especially in periods of active hostilities, sharp surges in demand have strained the economy's potential, generating inflationary pressures.

### SHORT-RUN INSTABILITY

All of the elements of demand have at times been sources of economic fluctuations. In the private sector, variations in the strength of demand have most often been concentrated in investment—inventory accumulation, business outlays for fixed capital, and residential construction expenditures.

#### *Elements of Demand*

Inventory stocks serve primarily as a buffer to ensure a smooth and efficient flow of material supplies and production and to guard against unforeseen increases in sales. Once inventory stock has been built up to a level adequate to cover a few months' production or sales, further accumulation is necessary only insofar as increases in sales are anticipated. Thus inventory investment can be sustained only by a steady expansion of sales.

Even relatively small variations in the rate of growth of sales can have sizable effects on inventory investment. An unexpected slowdown in demand, for example, will initially leave unsold goods on the shelves. Businessmen will wish to work off these excess inventories, and if they expect sales to continue at a slower pace, they will reduce their desired levels of future inventories. Cutbacks in production will then follow. As illustrated by the \$17½ billion drop in the annual rate of inventory accumulation in early 1967, such fluctuations can be a major source of instability.

Businessmen invest in new plant and equipment to increase and modernize their productive capacity. The rate of current capacity utilization, anticipated growth in demand, corporate cash flow, relative costs of capital and labor, and borrowing costs all influence investment decisions. Responses to changes in these factors are neither smooth nor readily predictable; and because of the long leadtimes generally involved in the production of capital goods, such responses may be spread out over a considerable period of time. But fluctuations in capital spending have often been an important source of instability. For example, real investment (constant prices) rose by 42 percent between 1963 and 1966, contributing to a strong expansion of aggregate demand, but then leveled out in 1967.

The third component of investment, homebuilding, is dependent upon family formation and income, with the availability of mortgage funds often acting as a major constraint, particularly in the short run. Because credit conditions generally tighten when the economy is expanding rapidly and ease when growth slows down, residential construction has frequently moved opposite to the path of over-all economic activity, contracting when the rest of the economy has been booming.

Consumer outlays normally follow the path of household incomes fairly closely. But such spending has also occasionally been an independent source of economic instability. Because consumption accounts for more than 60 percent of GNP, relatively small shifts in consumer demand have large impacts. The increase of 1 percentage point in the personal saving rate that occurred between 1966 and 1967, for example, directly reduced consumer expenditures by more than \$5 billion. Fluctuations are particularly pronounced in consumer purchases of automobiles and other durable goods.

The volatility of expenditures that makes for economic instability is by no means confined to private demand. Sudden changes in Federal spending have, on occasion, seriously disrupted the stability of the economy. Indeed, the rapid expansion of defense expenditures early in the Korean war, the rapid decline in 1953–54, and the upsurge of outlays for Vietnam in 1965–67 challenged economic policy as much as any change in the strength of private demand during the past 20 years.

### *Multiplier Process*

An autonomous increase in demand and production in any sector can be expected to work through the economy by raising disposable income

and hence consumer expenditures, by encouraging greater inventory accumulation, and by creating incentives for additional investment in plant and equipment. This cumulative expansion is known as the "multiplier process."

The results of this multiplier process are affected by the amount of unused resources available in the economy. At times of high unemployment and extensive unutilized capacity, an initial stimulus in demand is likely to be reflected primarily in a rise in real output with very little additional pressure on prices. But in an economy already operating at or above potential, where additional resources are not readily available, the main result may be upward pressure on prices with relatively little gain in real output.

Developments in financial markets may influence the magnitude of the multiplier. Increases in demands for goods and services will tend to enlarge credit demands. Unless monetary policy permits supplies of funds to expand correspondingly, interest rates will rise and credit will become less readily available. In that event, some offsetting reduction is likely to take place in residential construction and other credit-sensitive expenditures. Generally this will be a partial offset, varying according to how much the supply of credit is permitted to expand.

#### AUTOMATIC STABILIZERS AND FISCAL DRAG

The potential sources of instability discussed above produced four recessions between 1948 and 1961. By prewar standards, these recessions were all relatively short and mild, though nevertheless costly. They were limited in intensity and duration by several elements built into the fiscal system which serve to moderate economic instability in an automatic and passive fashion. These so-called "automatic fiscal stabilizers" operate to bolster income flows to households and business firms in periods of declining output and, conversely, to slow down the growth of income in periods of expansion.

Almost every tax—including State and local taxes—responds in some degree to changes in economic activity. Federal personal income tax collections are particularly responsive to such changes. They are the most important automatic fiscal stabilizer, cushioning take-home pay against fluctuations in the before-tax incomes of individuals. Another important stabilizer is the automatic expansion of unemployment compensation benefits when unemployment increases. The corporate income tax serves to reduce fluctuations in after-tax profits and hence in business investment outlays and dividend payments.

By reducing the size of secondary effects on consumer and business outlays, these stabilizers reduce the severity of economic fluctuations. With the present tax system and schedules of unemployment compensation benefits, a decline in GNP automatically produces a reduction in government receipts and an increase in transfer payments. This limits the decline in private after-tax income—disposable personal income and retained corporate profits—to about 65 cents for each \$1 of reduction in GNP.

During the postwar period, the automatic fiscal stabilizers have been a major factor in reducing economic instability. They go to work at once and avoid the delays inherent in discretionary action. But valuable as these automatic stabilizers are, they work only to limit—not prevent—swings in economic activity. For example, they become operative in a recession only after the decline has begun and cannot, by themselves, generate a recovery. If the factors causing a downturn are strong and persistent, automatic stabilizers may not be powerful enough to prevent a long and severe recession.

The automatic stabilizers also operate without regard to the over-all level of economic activity. If the economy has fallen substantially below the path of potential output, the return to that path is made more difficult by the retarding effects of automatic fiscal stabilizers. The existence of the automatic stabilizers in such a situation means that a larger amount of fiscal or monetary stimulus—increased expenditures, reduced tax rates, or easing of credit conditions—will be required to achieve the needed increase in aggregate demand.

In addition, automatic stabilizers work in a fashion that may inhibit the long-run expansion of demand. As the economy moves along the potential output path with reasonably stable prices, the Federal tax system generates an increase in revenues of about 6 percent a year. Unless this revenue growth is offset by reductions in taxes or by increases in expenditures, it acts as a “fiscal drag” by siphoning off income. Actions by the private sector can conceivably offset this effect if businesses increase investment expenditures faster than the growth of internal funds, or if households reduce their rate of saving. But under normal conditions, needed expansion may be prevented.

In interpreting the economic impact of fiscal policy, it is essential to distinguish between the automatic changes in revenues and expenditures resulting from the operation of the automatic stabilizers, on the one hand, and discretionary changes brought about by changes in tax rates and expenditure programs, on the other. In order to measure the impact of discretionary fiscal policy, it is useful to prepare estimates of revenues and expenditures at a given—or “standardized”—level of income. When the difference between revenues and expenditures is estimated at the level of potential output, the result is sometimes referred to as the “full employment surplus.”

The full employment surplus was a particularly enlightening measure of fiscal policy in the early 1960's when the economy was far below its potential. Actual Federal budgets were then in deficit. But after taking account of the large shortfall in tax revenues associated with the gap between potential and actual output, there was a large full employment surplus. It meant that the economy could realize its potential only if private investment far exceeded private saving. By that standard, discretionary fiscal policy was highly restrictive.

The vigorous and unbroken expansion of the last 8 years is in dramatic contrast to the 30-month average duration of previous expansions. No longer

## THE RECORD OF POLICY

is the performance of the American economy generally interpreted in terms of stages of the business cycle. No longer do we consider periodic recessions once every 3 or 4 years an inevitable fact of life.

The forces making for economic fluctuations have been contained through the active use of fiscal and monetary policies to sustain expansion. The record of these policy actions is briefly surveyed in this section. A detailed review of the objectives and effects of monetary and fiscal actions from 1961 through 1967 was presented in last year's Annual Report. The discussion below summarizes some particularly pertinent aspects of the magnitude and scope of these actions. Subsequent sections discuss some of the problems of economic diagnosis and policy formulation in light of experience.

### STRATEGY FOR EXPANSION: 1961 TO MID-1965

A series of deliberately stimulative fiscal measures was undertaken from 1961 to mid-1965 to bring the economy up to full potential. The net magnitude of these actions is summarized in Table 8. The \$37½ billion total of expansionary actions—expenditure increases and net tax reductions—more than offset the \$30½ billion estimated normal growth of revenues.

Early actions on the expenditure side included an acceleration of a scheduled increase in social security benefits in 1961, liberalization of public assistance payments, and a step-up in defense purchases as part of a general

TABLE 8.—*Federal fiscal actions in three periods since fourth quarter 1960*

[Billions of dollars, seasonally adjusted annual rates]

Item	1960 IV to 1965 II	1965 II to 1967 IV	1967 IV to 1968 IV <sup>1</sup>
Federal expenditure increases <sup>2</sup> .....	25.6	48.9	18.2
Defense purchases.....	3.4	25.4	5.4
Other purchases.....	7.4	2.8	2.6
OASDHI <sup>3</sup> benefits.....	5.0	10.0	5.2
All other <sup>2,4</sup> .....	9.8	10.7	5.0
Federal tax reductions <sup>5</sup> .....	12.0	-6.0	-13.0
Corporate.....	5.5	-----	-3.5
Personal.....	8.5	-----	-7.3
OASDHI <sup>3</sup> payroll taxes.....	-3.0	-8.5	-2.2
Indirect business.....	1.0	2.5	-----
Total expansionary actions <sup>6</sup> .....	37.6	42.9	5.0
Normal revenue growth at full employment.....	30.5	27.0	14.0
Change in full employment surplus <sup>7</sup> .....	-7.0	-16.0	9.0

<sup>1</sup> Preliminary.

<sup>2</sup> Includes adjustment in unemployment insurance benefits for change in unemployment rate.

<sup>3</sup> Old-age, survivors, disability, and hospital and related insurance (OASDHI).

<sup>4</sup> Consists of transfers other than OASDHI, grants, interest, and subsidies.

<sup>5</sup> Minus sign indicates an increase in tax.

<sup>6</sup> Sum of expenditure increases and tax reductions.

<sup>7</sup> Normal revenue growth minus expansionary actions.

Note.—Detail will not necessarily add to totals because of rounding.

Sources: Department of Commerce and Council of Economic Advisers.

realignment of our military forces. On the revenue side, stimulus to private investment was provided by a revision of depreciation guidelines and enactment of an investment tax credit of 7 percent on purchases of machinery and equipment in 1962. These measures were partially offset by increases in social security taxes in 1962 and 1963.

The net stimulus from these actions worked in the right direction, but was inadequate to the major task of reaching potential output. In the middle of 1962, business investment demand proved disappointingly weak, and the pace of economic expansion slowed. In the absence of Congressional action on President Kennedy's tax reduction program in 1963, the budget again moved toward an unduly restrictive position.

Tax reduction finally became a reality in the Revenue Act of 1964, which was President Johnson's first major legislative victory. This tax cut was unprecedented in many respects. When fully effective in 1965, it added more than \$11 billion to private purchasing power—the largest stimulative fiscal action ever undertaken in peacetime. It was enacted while the Federal budget was in deficit and while expenditures were rising. It was designed explicitly to sustain and invigorate expansion up to potential output rather than to combat an existing or imminent recession. This major action was followed by the enactment of a phased reduction in excise taxes in the spring of 1965.

Monetary policy also made an important contribution to the economic expansion by consistently accommodating growing credit demands at remarkably stable interest rates. A vigorously expansionary monetary policy which would have pushed interest rates to very low levels might, of course, have helped bring the economy to high employment more quickly. But such a decline in interest rates could have caused increased capital outflows from the United States, further impairing our balance-of-payments position. A series of actions by the Federal Reserve and the Treasury did actually raise U.S. short term interest rates during this period to bring them more into line with rates abroad. As shown in Chart 7, however, the upward pressure on short term rates did not spill over into long term markets.

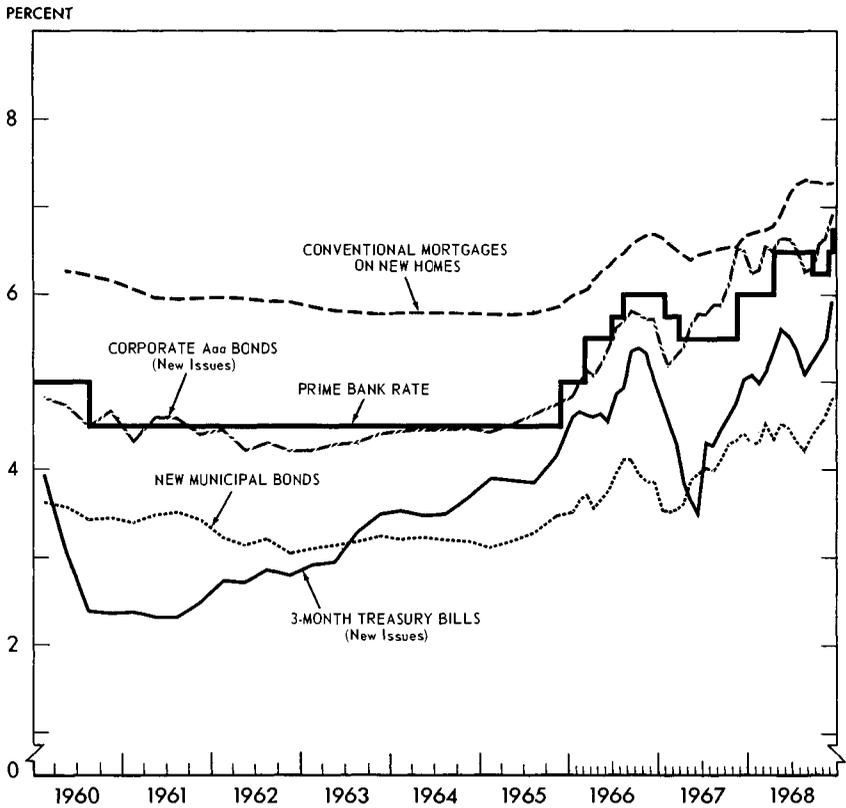
Decisions by the Federal Reserve at the beginning of 1962, in mid-1963, and in late 1964 to increase the maximum interest rates commercial banks could pay on time and savings deposits gave banks greater freedom to compete for funds. This enabled the banks to play an aggressive role throughout the period in tapping the market for liquid savings and re-channeling the funds into loans and investments.

#### FISCAL PROBLEMS OF DEFENSE AND HIGH EMPLOYMENT: 1965-68

By mid-1965, the unemployment rate had been reduced to about 4½ percent, and the gap between actual and potential output was being narrowed gradually and steadily. At this point, defense orders and expenditures

Chart 7

## Selected Interest Rates



NOTE—DATA PLOTTED ARE QUARTERLY THROUGH 1965, MONTHLY THEREAFTER.

SOURCES: FEDERAL HOUSING ADMINISTRATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, MOODY'S INVESTORS SERVICE, AND TREASURY DEPARTMENT.

began to build up rapidly, and the task of economic policy became considerably more complicated. The increase in defense activity reinforced a strong expansion of business spending on plant and equipment. The result was an excessively rapid growth of economic activity which generated inflationary pressures.

Some fiscal action to restrain the economy was taken in 1966. A previously enacted rise in payroll taxes of \$6 billion took effect at the start of the year. This was followed by prompt enactment of a series of tax measures proposed by the President in January—the reinstatement of some excise taxes that had been reduced, and the introduction of a system of graduated withholding of individual income taxes and of accelerated payments of corporate taxes. But even with these actions, fiscal policy remained strongly and inappropriately expansionary—in large part because defense spending continued to outrun expectations. As the President has recently made clear

in reviewing the record, he discussed a recommended general rise in taxes privately with business and Congressional leaders early in 1966 and became convinced that a tax increase could not be enacted. In the fall, added fiscal restraint was provided by a temporary suspension of the investment tax credit and cutbacks in nondefense spending.

In the absence of a full measure of timely fiscal restraint, an undue share of the burden of dampening the excessive expansion fell on monetary policy. In December 1965, the Federal Reserve raised the discount rate from 4 to 4½ percent and increased the maximum allowable interest rate on time deposits of commercial banks. As interest rates on bank time deposits and in the open market rose sharply, savings and loan associations and mutual savings banks experienced a sharp drop in their deposit inflows and thus had to cut back their lending to the homebuilding sector. These developments are described in more detail later in this chapter.

The result of these actions was a marked slowing in the growth of final demand. But homebuilding bore a disproportionate share of the restrictive impact. Moreover, interest rates ratcheted sharply upward to the highest levels in several generations, and a near-crisis atmosphere developed in financial markets in August 1966.

Because production continued to advance when final demand initially slowed, inventories increased rapidly late in 1966. The ensuing turn-around in inventory investment sharply accentuated an economic slowdown early in 1967, and the rate of price increase also slowed notably. Rising Government spending helped to maintain over-all expansion in the face of the large inventory adjustment in early 1967. And with easier credit stimulating homebuilding, strong expansionary forces reasserted themselves in the second half of that year. In August, President Johnson urged enactment of a 10-percent income tax surcharge. Delay in the passage of this measure intensified inflationary pressures and placed monetary policy in an awkward position as discussed in Chapter 1.

## LESSONS OF THE POLICY RECORD

In most respects, the economy has performed extremely well in the last 8 years, and vigorous use of fiscal and monetary policy has contributed to this good performance. But the record could have been better, and it provides several lessons that should serve as guides for the future.

First, the fiscal and monetary policy actions that were taken deliberately to influence economic activity generally worked in the right direction with effective results. Most of the shortcomings of the period were errors of omission rather than commission. This applies both to the delays in taking adequate stimulative action in 1961–63 and to the more recent delays in achieving fiscal restraint.

Second, the experience of 1961–65 demonstrated that an effective fiscal policy to stimulate the economy could be carried out without adding unnecessarily to the size of the Federal budget. Since the aims of stabilization

policy can be implemented either through tax changes or expenditure changes, decisions regarding Federal expenditures can be properly based on the desired allocation of resources between the public and private sectors.

Third, the record testifies to the effectiveness of a restrictive monetary policy in slowing down the economy, but also to its substantial undesirable side effects in bearing down on homebuilding and straining the financial system. The side effects point to the need for active fiscal policy to avoid placing a disproportionate share of the burden of economic stabilization on monetary policy.

The major shortcomings of economic policy in recent years can be traced to difficulties in achieving prompt and appropriate adjustments in fiscal policy to offset variations in the strength of private demand and substantial changes in defense spending. The next section discusses some improvements that might be made in the formulation and implementation of fiscal policy.

### FORMULATING FISCAL POLICY

The focus of fiscal policy in the United States is the annual Federal budget, which is presented in the Budget Message of the President in January. This budget covers the fiscal year starting 6 months later, on July 1. Any analysis of fiscal policy must begin with a consideration of the way in which this budget is formulated in the Executive Branch and the procedures by which the Congress acts on the President's recommendations.

The requirements of economic stabilization are not always fully met, however, by the fiscal program incorporated in the annual budget, no matter how carefully this program is formulated. Conditions may change during the course of the year in such a way as to call for a significant policy response after the annual budget has been planned. Some degree of continuing flexibility is therefore necessary.

One important forward step in budgetary practice was taken when the Federal budget for the fiscal year 1969 was presented. In accord with recommendations contained in the October 1967 Report of the President's Commission on Budget Concepts, a single unified budget was adopted, which covers in a comprehensive way all of the financial activities of the Federal Government. This unified budget provides a much improved statistical basis for formulating fiscal policy and evaluating its economic impact.

### THE ROLE OF ECONOMIC FORECASTING

A certain amount of time is required for the economy to respond fully to changes in fiscal—and monetary—policies, and the actions taken at one point in time have effects that are felt over a considerable subsequent period. Whether a policy action will help or impair economic performance depends on the state of the economy in the period following the action. It cannot be judged adequately just by the facts of the economic situation at the time the decision is taken. It must be assessed in light of a forecast.

The responsibility within the Administration for projections of Federal revenues, expenditures, and economic activity rests jointly with the Department of the Treasury, the Bureau of the Budget, and the Council of Economic Advisers. Liaison is maintained with the Federal Reserve Board, which must also forecast economic activity as a basis for its decisions concerning monetary policy.

These projections are particularly important in formulating the annual budget, and they are set forth regularly in the Council's Annual Report. But the evaluation of the economic situation and outlook must be kept up to date during the year. Thus the forecasts are revised for internal use as new information becomes available—indeed, the process of assessing the economic outlook is essentially a continuous one. The projections are frequently supplemented by quantitative estimates of the probable effects of alternative policy actions which might be taken. Quantitative evaluations of the outlook have been prepared for the President essentially on a quarterly schedule ever since 1961. This procedure assures a regular review by the President, with his chief economic and fiscal advisers, of the suitability of the budget program for the needs of the economy.

The techniques used in preparing the Administration's economic projections have changed considerably over the years; but in general they depend on a set of quantitative relationships among economic magnitudes over time. The relationships that are relied upon may be based on formal statistical procedures, subjective expert judgment, or survey data.

To a considerable extent, forecasting relies upon the timely availability of data relating to the economy's past performance which can be used as a basis for projecting its future behavior. Although there are still gaps in economic statistics, considerable progress has been made in recent years by the Department of Commerce, the Department of Labor, and other Federal Government agencies in increasing the quantity and improving the quality of statistical data available for assessing the performance of the economy.

Government agencies also collect valuable information on the anticipated future behavior of some categories of expenditures. For example, the quarterly survey of investment anticipations provides a useful indication of the probable behavior of this highly volatile element of private demand. The Bureau of the Budget prepares up-to-date estimates of future Federal expenditures. Estimates of Federal tax revenues are prepared and kept current by the Treasury Department.

Forecasting was notably successful in gauging in advance the rapid expansion of 1964 and the upsurge from late 1967 into 1968. On some occasions, however, difficulties have been encountered. The strength of the 1965–66 boom was not fully foreseen. Unexpected increases in the personal saving rate intensified the slowdown in economic activity that occurred in the first half of 1967. In the second half of 1968, private demand was

stronger than had been anticipated, as noted in Chapter 1. Nevertheless, the whole record makes clear that explicit quantitative projections are superior to extrapolations or hunches, which are the only alternative ways of guiding policy decisions that affect the future.

The need for greater precision in both forecasting and policy formulation has increased greatly in recent years. Between 1961 and 1965, when actual output was consistently below potential, there was little threat of a serious rise in prices, and the risks of excessive expansion were small. Thus emphasis could be placed upon achieving a growth of actual output in excess of that of potential in order to close the gap. Since 1965, however, as actual output has remained relatively close to potential, the need to anticipate and to offset fluctuations in demand has correspondingly increased.

### PREPARING THE ANNUAL BUDGET

The Federal budget should be formulated with two objectives in view. One is to provide the amount of fiscal stimulus or restraint needed to keep the economy moving along the potential output path—or to move it back toward that path if a departure has occurred. The other is to choose a level of Federal expenditures that provides the appropriate allocation of national resources between private and public uses. In principle, these two objectives can be pursued independently, since fiscal stimulus or restraint can be provided either by adjusting public expenditures or by adjusting tax rates to influence private spending.

#### *Determining the Extent of Expansionary Action*

In developing a budget that is appropriate in terms of fiscal impact, it is necessary at the outset to prepare an economic forecast for a period extending a year and a half beyond the time of budget presentation. The forecast covering the first 6 months of this period—for which the budget outlook has already been fairly well determined—provides the point of departure for viewing economic prospects in the ensuing fiscal year. From that point on, forecasts of private demand are used to determine the appropriate degree of fiscal stimulus or restraint to be provided by the budget.

This determination takes account of the growth of Federal revenues when GNP grows in line with potential in a noninflationary environment at unchanged tax rates. When the economy is in reasonable balance on the path of potential output and private demand is expected neither to weaken nor to accelerate, the forecast will point to the need for expansionary fiscal action sufficient to offset the fiscal drag exerted by normal revenue growth.

If the projection suggests that private demand will weaken or if the economy is operating below potential at the beginning of the year, expansionary fiscal action will be called for in an amount more than sufficient

to counteract the restraining effects of normal revenue growth. Conversely, if private demand is expected to strengthen or if the economy is operating above potential at the beginning of the year, an amount of expansionary fiscal action less than sufficient to offset the restraining effects of normal revenue growth will be required—or, in an extreme case, some additional restraint, beyond that provided by normal revenue growth, may be necessary.

The desired amount of expansionary (or restrictive) fiscal action, as indicated by the forecast, can be provided either by increasing (reducing) Government expenditures, by reducing (increasing) tax rates, or by some combination of the two. A decision therefore has to be made whether to adjust taxes, or expenditures, or both. This decision involves difficult choices about the allocation of resources between public sector programs and the private sector.

### *Public Expenditures and Tax Changes*

In order to make these choices intelligently, it is necessary to examine carefully the proposed Federal expenditures having the highest priorities—whether they be for the expansion of existing programs or for new initiatives—and judge whether the public needs that would be met by these programs are more or less urgent than the demands of the private sector that would be satisfied by tax reduction.

Allowance ordinarily has to be made for a virtually unavoidable increase in expenditures sufficient to keep pace with rising costs and rising workloads under existing Federal programs. The decision would, however, still have to be made whether any needed restraint or additional stimulus over and above that provided by this built-in expenditure growth should come from changes in tax rates or in expenditures.

All of this suggests that there is no reason to suppose that the proper allocation of resources between public sector and private sector activities would be achieved by keeping tax rates constant and adjusting Federal expenditures to meet the requirements of fiscal policy. It should be perfectly normal for the President to recommend a change in tax rates in his annual Budget Message. Such proposed changes have in fact been a feature of the last seven annual budgets. Indeed, consideration of the appropriateness of tax rates should be a normal part of the budget program—if no change is being proposed, the President should explain why existing tax rates are regarded as appropriate. If Government expenditures move ahead year by year at a rate about equal to the growth of tax revenues, changes in tax rates may not need to be made very often. However, it would be a remarkable coincidence if a steady growth in Government expenditures at that rate simultaneously satisfied the needs of economic stabilization and the Nation's wishes over the long run with respect to the proper allocation of resources between the public and private sectors of the economy.

Sharp increases in defense spending pose special issues relating to the

allocation of resources between Federal nondefense programs and the private sector. A sharp increase in defense expenditures normally requires a compensating fiscal adjustment to prevent the budget from becoming undesirably stimulative. In principle, any needed adjustment can be accomplished either by increases in tax rates or reductions in Federal nondefense outlays. For a number of reasons, however, increases in tax rates should normally be the main instrument. First, sharp slashes in Federal nondefense programs are simply not administratively feasible in the short run. Second, social priorities for the nonmilitary public sector would be violated if these programs carried the major burden of fiscal adjustment. The overhead cost on society of increased defense requirements should be expected to be borne primarily by the 80 percent of GNP that represents private uses of output. It seems evident that the roughly 10 percent of GNP which Federal nondefense spending represents should not be expected to carry the major part of the load. This seems particularly compelling in a Nation which is affluent in general and yet beset by serious social problems. While it is entirely appropriate for some types of nondefense spending to be cut and stretched out in order to ease the fiscal problem, there are strong grounds for avoiding reductions in social programs that deal with the urgent problems of poverty and urban blight.

#### CONGRESSIONAL PROCEDURES

If fiscal policy, as embodied in the annual budget, is to make its maximum contribution to economic stabilization, some changes in Congressional procedures for reviewing and determining the budget would be desirable.

##### *General Budget Review*

One important problem lies in existing Congressional procedures for determining budget authority and hence Federal expenditures. In both the House and Senate, budget authority is essentially controlled by 13 separate appropriations subcommittees which determine budget authority for individual agencies and programs. Their individual decisions can lead to a total of budget authority and outlays that is not controlled nor determined in a coordinated way. The Legislative Reorganization Act of 1946 called for a concurrent resolution on an expenditure total in advance of appropriations, but this limitation was not integrated into the appropriations procedures.

Congress needs new machinery which ensures that the actions taken on authorizations and outlays for particular programs will add up to a total that achieves an appropriate allocation of resources between Federal programs and the private sector of the economy. This machinery should focus specific attention on the level of taxes required in conjunction with any given total of outlays in order to achieve an appropriate fiscal policy. In making its judgments on these matters, the Congress would presumably begin with the Administration's expenditure and tax recommendations as con-

tained in the January Budget. Then, assuming no major disagreement with, or change in, the basic economic outlook, any proposals to change the expenditure total substantially from that recommended in the Budget should be accompanied by a corresponding proposal for adjusting taxes. If such machinery could be satisfactorily introduced, it would help produce a more coordinated Congressional decision on both expenditures and taxes.

### *Procedures for Tax Changes*

Procedures for a general review of the economy's fiscal needs along lines suggested above should expedite whatever specific action on taxes might be needed for fiscal policy purposes. In most circumstances, normal Congressional procedures for enacting the needed tax legislation would probably be satisfactory—especially if the Congress were to agree in advance on a form of tax adjustment that would be judged appropriate for this purpose. A proportional change in individual and corporate income taxes—like the current surcharge—might be a suitable form of adjustment.

However, the experience of the 1960's, including the costly delays in the passage of the 1964 tax cut and the 1968 tax surcharge, suggests the desirability of some other standby arrangement for obtaining prompt adjustments in tax rates to achieve fiscal policy objectives in case of a delay in reaching a decision through normal Congressional procedures. As noted in Chapter 1, the Administration has requested that the Congress consider giving the President discretionary authority, subject to Congressional veto, to remove the current surcharge entirely or partially if warranted by developments. A more permanent arrangement to provide the desirable flexibility could take various forms, including:

1. Presidential discretion to propose temporary changes in personal income tax rates within certain specified limits—such as 5 percent in either direction—subject to veto by the Congress within (say) 30 days. This year's Budget Message contains such a proposal.

2. A streamlined Congressional procedure for ensuring a prompt vote on Presidential proposals for changes in tax rates within certain specified limits. This would not shift any of the traditional powers of Congress to the President; the Congress would simply change its own rules.

Since changes in tax rates required for fiscal policy objectives would probably take the form of simple modifications of the basic schedule of rates, it would be necessary also to ensure opportunities for a thoroughgoing review of the over-all structure of the revenue system, including the tax base and rates. A structural review of rates would be especially appropriate if rates should drift downward (or upward) consistently for a period of several years as a result of fiscal adjustments. It is important, however, that the issues of tax reform be treated and considered separately from the annual tax decisions related to fiscal policy.

## ADJUSTING TO NEW DEVELOPMENTS

Under the procedures outlined above, it would surely take several months for full legislative response to the President's January Budget. During that period, both the Congress and the Administration would be alert to any major unanticipated developments in the strength of private demand, in Federal defense needs, and in the desired mix of fiscal and monetary policy. Any such developments could and should be reflected in the implementation of the budget program.

If the annual budget is carefully formulated and implemented, the need for a significant subsequent revision of the budget program later in the year should be the exception rather than the rule. Stabilization requirements could largely be met by reliance on automatic stabilizers and monetary policy.

Much of the success of these stabilization efforts would depend upon the Federal Reserve's flexibility in adjusting monetary policy to circumstances as they unfold. In the development of the annual budget, there should be close consultation and coordination with the monetary authorities. A tentative projection of monetary and credit conditions should be prepared as part of the forecast underlying annual budget decisions. The fiscal program should minimize the risk of putting an excessive share of the burden of economic stabilization on monetary policy, as happened in 1966. But monetary policy should not be bound by the projections made at budget time—if conditions change, it should be adjusted accordingly. Indeed, given a reasonably appropriate fiscal policy, the further adjustments needed to keep the economy reasonably close to potential output should normally be within the capability of the Federal Reserve.

It should be recognized, however, that major unforeseen developments may significantly modify the path of demand anticipated in the annual budget. As mentioned earlier, private demand has on occasion exhibited substantial unexpected strength or weakness.

A major problem in recent years has stemmed from the uncertain path of increases in defense spending during the Vietnam buildup. While it is to be hoped that such a military buildup will not again be necessary, there can be no assurance in an insecure world that this will be the case. Accordingly, it is essential to be prepared to deal with such contingencies. Moreover, there could be similar and equally challenging problems of gauging the magnitude and timing of a demobilization—when peace is established. A special report to the President discussing the challenges and opportunities that will confront policymakers when peace comes in Vietnam is included in this volume.

The path of defense orders and outlays is inherently difficult to predict in a period of military flux. Through intensified efforts of the Department of Defense, considerable progress has nevertheless been made in providing an improved flow of information relating to both the current and prospective economic impact of defense spending. Some of this information is now being made public by the Bureau of the Census in a monthly digest entitled

*Defense Indicators.* Further efforts are needed, together with a full awareness of the importance of accurate information, especially at critical turning points in the trend of defense spending.

## SOME ISSUES OF MONETARY POLICY

The record of the past 8 years demonstrates that flexible, discretionary monetary policy can make an effective contribution to economic stabilization. The economy's gradual return to full productive potential in the early 1960's was partly attributable to a monetary policy which kept ample supplies of credit readily available at generally stable interest rates. And in early 1967, the prompt recovery of homebuilding after the 1966 slowdown was the direct result of timely and aggressive easing of credit conditions by the Federal Reserve.

The most dramatic demonstration of the effectiveness of monetary policy came in 1966, however, when a dangerously inflationary situation was curbed primarily by a drastic application of monetary restraint. Credit-financed expenditures at the end of that year appear to have been as much as \$8 billion below what they might have been had monetary policy maintained the accommodative posture of the preceding 5 years. And there were substantial further "multiplier" effects on GNP as these initial impacts reduced income and consumption spending.

## THE CONDUCT OF MONETARY POLICY

The primary guides for monetary policy are the various broad measures of economic performance, including the growth rate of total output, the relation of actual to potential output, employment and unemployment, the behavior of prices, and the Nation's balance-of-payments position. Extensive research, together with the experience of the last few years, has increased our knowledge of the complex process by which monetary policy influences these measures. While there are still major gaps in our knowledge of the precise chain of causation, some conclusions seem well established.

Like fiscal policy, monetary policy affects economic activity only after some lag. Thus actions by the Federal Reserve must be forward-looking. In considering the prospects ahead, however, an assessment must be made of both the expected behavior of the private sector and of the likely future course of fiscal policy. As noted earlier, the inherent flexibility in the administration of monetary policy permits frequent policy adjustments to take account of unexpected developments in either the private or the public sector.

### *Sectoral Impacts*

Monetary policy can affect spending through a number of channels. To some extent it works by changing the terms of lending, including interest rates, maturities of loans, downpayments, and the like, in such a way as to encourage or discourage expenditures on goods financed by credit. There

may also be market imperfections or legal constraints and institutional rigidities that change the “availability” of loans as monetary conditions change—that is, make it easier or more difficult for borrowers to obtain credit at given terms of lending. Under some circumstances, purchasers of goods and services may finance their expenditures by liquidating financial assets, and changes in the yields on these assets produced by a change in monetary policy may affect their willingness to engage in such transactions. Changes in monetary policy may also, on occasion, change the expectations of borrowers, lenders, and spenders in ways that affect economic conditions, although these expectational effects are rather complex and dependent upon the conditions existing at the time policy is changed.

Monetary policy affects some types of expenditures more than others. The extent of the impact depends not only on the economic characteristics of the activity being financed but, in many instances, on the channels through which financing is obtained and the legal and institutional arrangements surrounding the financing procedures.

*Residential Construction.* The sector of the economy most affected by monetary policy is residential construction. Although the demand for housing—and for mortgage credit—does not appear to be especially responsive to mortgage interest rates, the supply of mortgage funds is quite sensitive to several interest rate relationships.

The experience of 1966 clearly demonstrated how rising interest rates can sharply affect flows of deposits to banks and other thrift institutions and thereby severely limit their ability to make new mortgage loans. In the first half of that year, the net deposit gain at savings and loan associations and mutual savings banks was only half as large as in the preceding 6 months. These institutions could not afford to raise the rates paid on savings capital to compete with the higher rates available to savers at banks and elsewhere because of their earnings situation—with their assets concentrated in mortgages that earned only the relatively low rates of return characteristic of several years earlier. Commercial banks experienced a similarly sharp slowing in growth of time deposits in the second half of the year, as the Federal Reserve’s Regulation Q prevented them from competing effectively for liquid funds. This forced banks to make across-the-board cuts in lending operations.

In addition, life insurance companies had a large portion of their loanable funds usurped by demands for policy loans, which individuals found attractive because of relatively low cost. High-yielding corporate securities also proved an attractive alternative for some institutional investments that might otherwise have gone into mortgages.

Table 9 provides some indication of the extent of these various influences. As can be seen, savings and loan associations and mutual savings banks together supplied less than 10 percent of total funds borrowed in 1966, well below their 22 percent share in the preceding 5 years. This was the main

TABLE 9.—*Net funds raised by nonfinancial sectors, 1961–68*

Nonfinancial sector	1961–65 average	1966	1967	1968 <sup>1</sup>
Total funds raised (billions of dollars).....	59.2	69.9	83.1	97.1
Percent of total raised by:				
Private domestic nonfinancial sectors.....	84.5	88.7	79.9	80.4
State and local governments.....	10.8	9.7	12.6	11.7
Nonfinancial business.....	34.6	48.1	44.8	37.0
Households.....	39.0	30.9	22.5	31.7
Mortgages.....	25.5	18.6	13.7	17.1
Other.....	13.5	12.3	8.8	14.6
U.S. Government.....	10.6	9.0	15.3	16.7
Rest of world.....	5.1	2.1	4.8	2.9
Percent of total supplied by:				
Commercial banks.....	35.1	24.7	43.6	39.1
Nonbank financial institutions.....	43.6	32.2	39.0	29.7
Savings and loan associations and mutual savings banks.....	22.1	9.9	19.5	14.0
Other.....	21.5	22.3	19.5	15.7
Federal Reserve and U.S. Government.....	10.1	16.3	11.2	12.9
State and local governments.....	6.8	8.9	9.4	7.7
Foreign lenders.....	1.2	-2.0	3.9	-3
Nonfinancial business.....	2.7	4.6	.5	5.1
Households, less net security credit.....	.5	15.3	-7.5	5.8

<sup>1</sup> Preliminary.

Note.—Detail will not necessarily add to totals because of rounding.

Source: Board of Governors of the Federal Reserve System.

factor limiting the availability of household mortgage loans. The effect on homebuilding was quick and dramatic, as the seasonally adjusted volume of new housing units started fell by nearly half between December 1965 and October 1966.

In 1967, as interest rates in the open market retreated from their 1966 highs, the thrift institutions were able to regain their competitive position in the savings market. A good part of their funds was fairly quickly channeled into the mortgage market. By fall, housing starts had recovered nearly to the level of late 1965.

As noted in Chapter 1, many factors—including several significant institutional reforms, sharply improved liquidity positions, and the widespread expectation that monetary restraint was only temporary pending passage of the tax bill—helped to moderate the adverse effects of renewed monetary restraint on mortgage lending in 1968. But the thrift institutions again experienced some slowing of deposit inflows when market interest rates rose to new heights, and mutual savings banks switched a good part of their investments away from the mortgage market to high-yielding corporate bonds.

*State and Local Governments.* State and local governments also felt the effects of monetary restraint in 1966. These governments cut back or postponed more than \$2.9 billion, or nearly 25 percent, of their planned bond issues that year.

It is difficult to determine precisely what caused these postponements. In

cases involving more than half the dollar volume, the reasons given related to the prevailing high level of interest rates. In some instances, the interest costs simply exceeded the legal ceiling governments were permitted to pay for borrowed funds. In other cases, finance officers decided to delay bond issues for a few months in the expectation that interest rates would decline.

This sizable cutback in borrowings had a relatively small effect on State and local government expenditures. Larger governments apparently were able to continue most of their projects about as scheduled by drawing down liquid assets or borrowing temporarily at short term. Smaller governmental units, however, cut their contract awards by a total estimated at more than \$400 million.

Because of the problems State and local governments often face in raising funds, the Administration is proposing the establishment of an Urban Development Bank, which could borrow economically in the open market and then lend in the amounts needed to individual local governments. The Bank could lend at federally subsidized interest rates, with the Federal Government recovering the cost of the subsidy through taxation of the interest income earned by holders of the Bank's securities.

*Business and Consumer Spending.* The 1966 credit squeeze undoubtedly also had some effects on business and consumer spending, though the amount of impact is not easily determinable. Most theoretical and empirical studies find that business firms in some way balance the cost of borrowed capital against the expected returns from their capital projects. Some small firms may also simply not be able to obtain funds during tight money periods. In 1966, bank lending to business did slow sharply during the second half of the year. Many of the larger firms shifted their demands to the open market—and paid record high interest rates for their funds—but some of the smaller ones probably were forced to postpone their projects.

Household spending on durable goods—particularly automobiles—has been shown to be affected by changes in the cost and availability of consumer credit, as reflected in the interest rate, maturity, downpayment, and other terms. While it is difficult to sort out cause and effect, households borrowed only two-thirds as much through consumer credit in the second half of 1966 as in the preceding half year. Capital gains or losses on asset holdings accompanying changes in yields may also induce consumers to spend more or less on goods and services.

### *Active and Passive Elements*

Monetary policy, like fiscal policy, has what might be termed active and passive components. Recognition of this distinction played an important role in formulating the accommodative policy of the early 1960's. In the 1950's, economic expansion had generally been accompanied by rising interest rates, which tended to produce an automatic stabilizing effect somewhat

similar to the fiscal drag of the Federal tax system discussed earlier. The large amounts of underutilized resources available in the early 1960's made such restraint inappropriate, and credit was expanded sufficiently to prevent it from occurring.

It is especially important to distinguish between these elements in monetary policy at cyclical turning points. If, for example, private demand weakens and causes a decline in economic activity, interest rates will generally fall as credit demands slacken, even without any positive action by the Federal Reserve to push rates down. This induced fall in interest rates can help to check the decline in economic activity but may not, by itself, induce recovery. Similarly, as the economy rises above potential, the induced rise in interest rates may only moderate the expansion but may not bring activity back into line with capacity.

An active monetary policy during such periods requires positive effort by the Federal Reserve to produce further changes in interest rates and in availability of credit beyond those that would occur automatically. Since expectational responses may either accentuate or moderate the effects of the initial action, it is sometimes difficult to know in advance precisely how much of a policy change is needed. But the main point is clear—at such turning points, interest rate movements alone are not likely to provide an accurate reflection of the contribution of monetary policy to economic stabilization. Careful attention must also be paid to credit flows, particularly those to the private sector of the economy.

## MONETARY POLICY AND THE MONEY SUPPLY

Examination of the linkages between monetary policy and various categories of expenditures suggests that, in the formulation of monetary policy, careful attention should be paid to interest rates and credit availability as influenced by and associated with the flows of deposits and credit to different types of financial institutions and spending units. Among the financial flows generally considered to be relevant are: the total of funds raised by nonfinancial sectors of the economy; the credit supplied by commercial banks, the net amount of new mortgage credit, the net change in the public's holdings of liquid assets, changes in time deposits at banks and other thrift institutions, and changes in the money supply. Some consideration should be given to all of these financial flows as well as to related interest rates in formulating any comprehensive policy program or analysis of financial conditions.

Much public attention has recently been focused on an alternative view, however, emphasizing the money supply as the most important—sometimes the only—link between monetary policy and economic activity. This emphasis has often been accompanied by the suggestion that the Federal Reserve can best contribute to economic stabilization by maintaining growth in the stock of money at a particular rate—or somewhat less rigidly,

by keeping variations in the rate of growth of the money stock within a fairly narrow band.

There are, of course, numerous variants of the money view of monetary policy. The discussion below focuses only on the simple version that has captured most of the public attention.

### *Money and Interest Rates*

In a purely theoretical world, abstracting from institutional rigidities that exist in our financial system and assuming that relationships among financial variables were unvarying and predictable, it would make little difference whether monetary policy was formulated in terms of interest rates or the money supply. The two variables are inversely related, and the alternative approaches would represent nothing more than different paths to precisely the same result. The monetary authorities could seek to control the money stock, with interest rates allowed to take on whatever values happen to result. Or alternatively, they could focus on achieving the interest rates that would facilitate the credit flows needed to finance the desired level of activity, allowing the quantity of money to be whatever it had to be.

But financial rigidities do exist that often distort flows of credit in response to swings in interest rates. And financial relationships have changed steadily and significantly. Just since 1961, several important new financial instruments have been introduced and developed, including negotiable time certificates of deposit and Euro-dollar deposits. Attitudes of both investors and lenders have also undergone marked shifts, with sharp variations in the public's demand for liquidity superimposed on an underlying trend toward greater sensitivity to interest rates.

There is, to be sure, enough of a link between money and interest rates at any given time to make it impossible for the Federal Reserve to regulate the two independently. But this linkage is hardly simple, and it varies considerably and unpredictably over time. The choice between controlling the stock of money solely and focusing interest rates, credit availability, and a number of credit flows can therefore make a difference. This choice should be based on a judgment—supported insofar as possible by empirical and analytical evidence—as to whether it is money holdings alone that influence the decisions of various categories of spending units.

### *Money and Asset Portfolios*

The Federal Reserve conducts monetary policy primarily by expanding and contracting the supply of cash reserves available to the banking system. Such actions seek to induce an expansion or contraction in loans and investments at financial institutions, with corresponding changes in the public's holdings of currency and deposits of various kinds. The proportions in which the public chooses to hold alternative

types of financial assets depend upon a complex set of preferences, which, in turn, depend upon interest rate relationships.

The process of expansion and contraction of money and credit stemming from Federal Reserve actions is fairly complex. But one aspect of it should be clearly understood: The money so created is not something given to the public for nothing as if it fell from heaven—that is, it is not a net addition to the public's wealth or net worth. There can be an immediate change in public wealth, but only to the extent that changes in interest rates generate capital gains or losses on existing assets.

Any change in the money stock is associated with a change in the composition of the public's balance sheet, as people and institutions are induced to exchange—at a price—one asset for another or to increase (or decrease) both their assets and their liabilities by equal amounts. Since all the items in the public's balance sheet might be changed as a result of these compositional shifts, the change in the public's liquidity is not likely to be summarized adequately in terms of any single category of financial assets.

It is, of course, possible that decisions to spend on goods and services are affected more by the presence of one type of financial asset than another in a spending unit's portfolio. But there is only scattered evidence of such behavior in various sectoral studies that have been undertaken to analyze the factors affecting the spending decisions of consumers, businesses, or State and local governments. Indeed, to the extent these studies do find spending decisions systematically affected by financial variables, it is often through changes in interest rates and availability of credit.

### *Money and Income and a Monetary Rule*

One problem with the money supply as a guide to monetary policy is that there is no agreement concerning the appropriate definition of "money." One definition includes the total of currency outside commercial banks plus privately held demand deposits. A second also includes time deposits at commercial banks, and even more inclusive alternatives are sometimes used. On the other hand, there is a more limited definition, sometimes called "high-powered money" or "monetary base," which includes currency in circulation and member-bank reserve balances at the Federal Reserve banks.

These different concepts of money do not always move in parallel with one another—even over fairly extended periods. Thus assertions that the money supply is expanding rapidly or slowly often depend critically on which definition is employed. In the first half of 1968, for example, there was a sharp acceleration in the growth of currency plus demand deposits, but growth of this total plus time deposits slowed considerably.

On the other hand, relationships between movements in GNP and any of the money concepts have been close enough on the average—especially when processed through complex lags and other sophisticated statistical techniques—to be difficult to pass off lightly.

There is, of course, good reason to expect some fairly close relationship between money and income. This would be true even in a completely abstract situation in which it was assumed that the money supply per se had no direct influence on GNP, and that monetary policy worked entirely through interest rates. Since interest rates and the money supply are inversely related, any rise in GNP produced by a reduction in interest rates and increased credit availability would be accompanied by at least some increase in the money supply.

The relationship also exists in a sort of "reverse causation" form—that is, as income goes up so does the demand for money, which the Federal Reserve then accommodates by allowing an increase in the actual money stock. This is precisely what happened during the 1961–65 period of accommodative policy, and it is always present to some extent as the Federal Reserve acts to meet the economy's changing credit needs. The problem of sorting out the extent of causation in the two directions still challenges economic researchers.

A one-sided interpretation of these relationships is sometimes used to support the suggestion that the Federal Reserve conduct policy on the basis of some fixed, predetermined guideline for growth of the money supply (however defined). Given the complex role of interest rates in affecting various demand categories and the likely variations in so many other factors, any such simple policy guide could prove to be quite unreliable.

The experience of the past several years illustrates the kinds of difficulties that might be encountered in using the money supply (defined here as currency plus demand deposits) as the exclusive guide for monetary policy. As described previously, high interest rates in 1966 began affecting the nonbank thrift institutions, the mortgage market, and the homebuilding industry soon after the start of the year. But during the first 4 months of that year, the money supply grew at an annual rate of nearly 6½ percent, well above the long-term trend. Later that year, the financial situation of major mortgage lenders improved somewhat and housing eventually rebounded despite the fact that growth of money supply plus bank time deposits was proceeding at only a snail's pace.

Growth of the money supply in the second quarter of 1968 was at an annual rate of 9 percent. The reasons for this acceleration—to a rate almost double the growth in the preceding quarter—are not fully apparent. The Federal Reserve could have resisted this sizable increase in the demand for money more than it did, but interest rates in the open market would then have risen well above the peaks that were in fact reached in May. Whether still higher rates would have been desirable is another issue, which cannot be settled merely by citing the rapid growth of the money supply.

These illustrations suggest that any simple rigid rule related to the growth of the money supply (however defined) can unduly confine Federal Reserve policy. In formulating monetary policy, the Federal Reserve must be able to take account of all types of financial relationships currently prevailing and in prospect and be able to respond flexibly as changing

economic needs arise. In deciding on such responses, especially careful consideration must be given to likely changes in interest rates and credit availability, in view of the effects of these factors on particular sectors of the economy—especially the homebuilding industry.

### LOOKING AHEAD

In the future as in the past 8 years, the maintenance of full prosperity deserves high priority among the Nation's goals because it contributes so much to so many of our other national objectives. Job opportunities provide the stepping stones out of poverty for many of the disadvantaged. As Chapter 5 makes clear, efforts to train the disadvantaged can hardly succeed in a sluggish economy. For those who have already obtained some minimum standard of living, prosperity offers a ladder to higher standards of comfort, civilization, and security. For those high on the income scale, prosperity provides the incentives and the funds for the growth of capital to strengthen our productive performance in the future. For the public sector, prosperity offers the revenues that can help to repair the accumulated decay of our cities, purify the environment, and improve education and transportation systems.

Between 1968 and 1975, our civilian labor force will increase by 10½ million persons, or an average of 1½ million a year. If the new entrants are employed and productivity continues to grow at the recent trend rate, GNP will amount to about \$1,150 billion (in 1968 prices) in 1975.

The experience of the past 8 years should be of considerable benefit in the formulation of economic policies to ensure continued movement along the potential output path to reach this level of GNP in 1975. Economic policymakers can reasonably hope to maintain sustained growth in line with potential and to avoid the bumps of the business cycle and the unconscionable waste of a slack economy.

A dynamic society should not, however, be satisfied merely with continuing along the present path of potential. Faster growth can be achieved if ways can be found to accelerate the growth of national productivity. Policies that aim at stimulating capital formation, education, and technological advance can play an important role. Additional gains in output and standards of living for all our citizens can be realized if ways can be found to achieve lower levels of unemployment and reasonably stable prices simultaneously. Chapter 3 discusses a number of measures that can help to make high employment and price stability more compatible.

## Price Stability in a High Employment Economy

**T**HE REMARKABLE ACHIEVEMENT of prosperity as the normal state of the American economy has been recorded in Chapter 2. Recent price performance has been far less satisfactory.

Since 1965, prices have been rising too rapidly. The history of both the United States and other industrial nations shows that high employment is generally accompanied by inflationary tendencies, and that when prices are reasonably stable, this is at the cost of too many idle men and idle machines.

The record of the past poses the critical challenge of the years ahead. Reconciling prosperity at high employment with price stability is the Nation's most important unsolved problem of over-all economic performance. Though the United States has done better than most industrial countries, its record is far from adequate. That record can and should be improved by measures discussed in this chapter.

### PRICES, WAGES, AND EMPLOYMENT

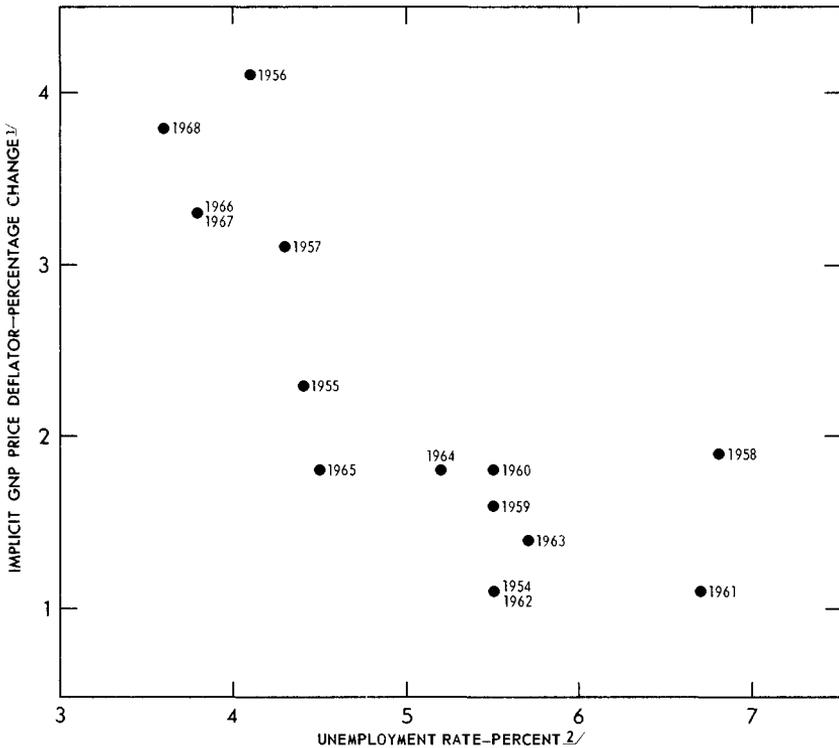
The difficulties of combining price stability and high employment in the past 15 years are evident in Chart 8. It reveals a fairly close association of more rapid price increases with lower rates of unemployment. In 1956-57 and from 1966 to 1968, when the unemployment rate was between 3.6 and 4.3 percent, price increases ranged between 3.1 and 4.1 percent. In contrast, between 1958 and 1964 the unemployment rate consistently exceeded 5 percent, and price increases were uniformly less than 2 percent.

The historical relationship has been neither mechanical nor precise. In some periods, the over-all price level has been affected by special and erratic factors such as crop failures, shifts in foreign demand, or bottlenecks arising from a spurt of demand in one sector of the economy. Moreover the price performance of any year is influenced by cost developments arising from conditions in prior years.

Still, upward pressures on prices and wages are likely to be intensified when the economy is operating at high utilization of manpower and capital. In a slack economy, rising prices are rarely a problem. Even when demand begins to expand strongly, additional output is readily provided by increases in employment and fuller use of industrial capacity. If the expansion persists

Chart 8

## Price Performance and Unemployment



1/CHANGE DURING YEAR, CALCULATED FROM END OF YEAR DEFLATORS (DERIVED BY AVERAGING FOURTH QUARTER OF A GIVEN YEAR AND FIRST QUARTER OF SUBSEQUENT YEAR).

2/AVERAGE FOR THE YEAR.

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

at a rate exceeding the growth of the economy's productive capacity, however, demand will begin to press upon available capacity in some industries. As a result, increases in prices will become more frequent, there will be fewer offsetting decreases elsewhere, and living costs will begin to rise. Shortages of workers with particular skills or in certain localities may develop, and wages will accelerate for these groups. Because the balance of demand and supply differs among industries, these tendencies may emerge even while over-all unemployment and unused capacity are substantial.

If demand continues to grow strongly, more industries and labor markets are strained and inflationary pressures become more pervasive. As unemployment declines, wages accelerate, since employers prefer to raise wages rather than jeopardize sales and profits through either strikes or inability to attract enough labor. The threat of losing markets through price

increases exercises much less discipline on the pricing policies of a firm when it (and its competitors) are operating close to capacity. Thus prices are readily marked up, both to reflect increased costs of labor and materials and to provide for higher profit margins.

With living costs rising, wage increases are stepped up in most industries and generally exceed the economy-wide growth of productivity. Thus unit labor costs rise and in turn tend to be translated into higher prices. In this way, a buoyant economy can move from price stability into a rising spiral of wage and price adjustments. And once such a spiral starts, it becomes increasingly difficult to arrest, even after productive capacity has caught up with demand and the initial pressures have largely subsided.

## THE RECORD IN THE SIXTIES

This sequence of events is illustrated by the performance of the U.S. economy in the 1960's.

### *Price Stability: 1961-65*

Between the first quarters of 1961 and 1965, rapid economic expansion took up much of the slack in the use of resources. The unemployment rate dropped from 6.8 percent to 4.8 percent (seasonally adjusted) during this 4-year period, and capacity utilization in manufacturing increased sharply.

Yet the price and wage record was excellent. Average hourly compensation in the private nonfarm economy rose an average of 4.0 percent annually, but productivity increased at a rate of 3.9 percent, so that unit labor costs remained virtually unchanged. The average level of wholesale prices in January 1965 was the same as 4 years earlier. Consumer prices advanced at a moderate annual rate of 1.2 percent, largely reflecting gradual cost increases in distribution and services where productivity gains come slowly.

### *The Price-Wage Upturn: 1965-68*

The first significant break in relative price stability occurred early in 1965. Farm and food prices began a sharp upward climb, spurred by special and erratic factors affecting supply at home and abroad. More pervasive inflationary pressures started in the second half of 1965 when the military buildup in Vietnam began. The rise in prices of consumer services accelerated as firms found it increasingly difficult to recruit and keep workers in the traditionally lower paying service jobs. With consumer prices rising more rapidly and with stronger demand for labor, upward pressures on wages mounted.

These developments show up clearly in the price and wage record. Between the second quarters of 1965 and 1966, consumer prices rose 2.7 percent. During the same period, average hourly compensation in the private

nonfarm economy jumped 6 percent, well above the growth of productivity; as a result, unit labor costs rose nearly 3 percent.

Wage and price developments were influenced by the high level of utilization of the economy. In January 1966, unemployment fell below 4 percent of the labor force for the first time in nearly a decade, and the utilization of manufacturing capacity reached the highest rate since 1955. But price pressures were also intensified by the unusually rapid speed of the advance, as reflected in an annual rate of growth in the real gross national product (GNP) of more than 8 percent between the second quarter of 1965 and the first quarter of 1966. Had the economy approached the neighborhood of 4 percent unemployment more gradually, there would have been more time to train and upgrade labor and to introduce newer and more efficient equipment.

When the rate of expansion slowed down late in 1966 and early in 1967, so did the upward movement of prices. Between August 1966 and April 1967, consumer prices continued to advance; but the annual rate of increase moderated to 2 percent, while average wholesale prices actually declined. An increase in supplies of farm products and other raw materials was especially helpful. As new facilities were completed, the pressures on manufacturing capacity decreased sharply, and price increases slowed down for a number of manufactured products.

Nevertheless, higher costs had been built into the economy during 1965 and 1966, and when the economy picked up speed in the second half of 1967, prices and wages again accelerated. Union settlements, which had lagged in the initial stage of the advance, rose especially sharply in late 1967 and in 1968. As discussed in Chapter 1, the problems of rising prices and wages remain intense as 1969 begins.

## THE TASK FOR POLICY

Because of the general relationship between prices and unemployment, decisions of fiscal and monetary policy present a serious dilemma. Achieving price stability by accepting high unemployment involves dreadful waste and tremendous social and human costs. But historically, unemployment rates of 4 percent or below have been associated with a price performance that most Americans consider unsatisfactory. As explained in Chapter 2, price increases at the rate recently experienced clearly impair our international trade performance, cause a haphazard redistribution of income and wealth, and may jeopardize sustained prosperity.

The first line of defense against inflation must be fiscal and monetary policies that avoid excessive pressures of demand on productive capacity. By heading off sudden surges in demand and by promoting steady and smooth growth, these policies can also contribute to improved price performance at high employment. But fiscal and monetary policies alone cannot ensure the simultaneous achievement of low rates of unemployment and reasonable

price stability. The relationship between inflation and unemployment depends upon the workings of the Nation's institutions and markets. There is need for a wide ranging attack on inflation that will bring about pervasive improvements in the economy's price performance.

To this end, the President established the Cabinet Committee on Price Stability early in 1968. The Committee has studied many aspects of the problem and has submitted its report, which covers many of the issues discussed below.

## IMPROVING LABOR AND PRODUCT MARKETS

Our labor and product markets are among the most efficient and flexible in the world. Yet their further improvement is the key to making higher levels of employment consistent with price stability. These markets must be even more responsive to changing patterns of demand, and they must continuously increase the productivity of our resources.

Measures to improve these markets are of two general but related kinds: those that facilitate the most productive use of our manpower resources, and those that improve the efficiency of our product markets.

The efficiency of labor markets is reflected in the matching of job opportunities and available manpower. The fit is never perfect: while in some areas and for some skills "help wanted" signs prevail, there are simultaneously many unemployed persons whose skills or locations do not fit the needs of employers. Continued job vacancies tend to pull wages up and thereby attract labor. In areas of excess supply, however, wages are rarely subject to strong downward pressures. Thus unmanned jobs and jobless men do not offset each other in influencing average wages. The better the labor markets operate, the higher the level of employment and the lower the volume of job vacancies that can accompany any degree of upward pressure on average wages.

There are a number of ways that a better and more flexible fit of available manpower and job opportunities can be achieved. Workers can move more easily between occupations and geographical locations if they are given improved information about job opportunities and if they are not confronted with barriers to entry into certain occupations. They can be aided by training programs which are more closely oriented toward skills that are in short supply. And the productivity of employed labor can be improved by the removal of restrictive work practices.

Measures of these kinds can both alter the level of employment consistent with reasonable price stability and add significantly to the real output produced at a given level of employment.

Product markets can also be made more efficient. The major thrust must be the strengthening of competition. Vigorous enforcement of antitrust policy is essential. Opportunities can be found to remove or reduce existing re-

straints on competition. Better information for the consumer can also strengthen competition. The continued pursuit of freer international trade can enhance the effectiveness of competition. Standards and policies in regulated industries, in agricultural programs, and in Government procurement should be kept under constant review, with price stability recognized as one of the goals of policy.

The major measures discussed below should be viewed as elements of a comprehensive program to improve price-cost behavior. Other areas and other possible policy actions could be added to the list. The effects of the measures vary considerably in potential magnitude, and no single one can ensure a significant advance by itself. Yet if progress can be achieved on most of these fronts, the inflationary tendencies that accompany low unemployment should be reduced.

Most of these measures may be expected to yield substantial gains in other directions. Some would increase employment opportunities for the disadvantaged. Others would enhance productivity and growth over the long run.

It must also be recognized that many of these measures involve some social and financial costs that have to be assessed against the potential benefits. In fact, some of the present problems result from past public or private policies designed to promote such objectives as job security, public safety or health, and the protection of small businesses. Frequently these policies were aimed at conditions which prevailed years ago; they require reexamination in today's high employment economy.

Structural improvements in our product and labor markets usually take time to institute and require time to show measurable effects. Most of the strategies cannot be counted upon to assist significantly in the immediate task of moving toward price stability in 1969. But early efforts are needed to make timely progress toward the long-run objective of combining high employment with reasonable price stability.

#### IMPROVING LABOR MOBILITY

Over the long term, there have been dramatic shifts in the pattern of demand for labor—from agriculture to manufacturing, from the production of goods to the supply of services, and from less to more highly skilled occupations. Agricultural workers represent only 5.0 percent of the civilian labor force as compared with 13.1 percent 20 years ago. The number of white collar workers has risen from one-third to nearly one-half of total employment since World War II, with an especially rapid rise in the number of professionals. The industry shifts in the past 7 years are shown in Table 10.

The needed adjustments to both short- and long-run changes in the demand for labor have been largely accomplished by the normal operation of the market. Increases in earnings have been particularly large in those occupations for which demand has been rising rapidly. For example, increased

TABLE 10.—Changes in employment, 1961 to 1968

Industry group	Millions of persons		Percentage change per year, 1961 to 1968 <sup>1,2</sup>	Percentage distribution <sup>2</sup>	
	1961	1968 <sup>1</sup>		1961	1968 <sup>1</sup>
Total employment.....	65.7	75.9	2.1	100.0	100.0
Agriculture.....	5.2	3.8	-4.3	7.9	5.0
Nonagriculture.....	60.5	72.1	2.5	92.1	95.0
Nonagricultural payroll employment.....	54.0	68.1	3.4	100.0	100.0
State and local government.....	6.3	9.5	5.9	11.7	13.9
Services.....	7.7	10.5	4.6	14.2	15.4
Retail trade.....	8.3	10.4	3.3	15.4	15.3
Finance, insurance, and real estate.....	2.7	3.4	3.0	5.1	4.9
Wholesale trade.....	3.0	3.7	2.9	5.5	5.4
Manufacturing.....	16.3	19.7	2.7	30.2	29.0
Production workers.....	12.1	14.5	2.6	22.4	21.3
Nonproduction workers.....	4.2	5.3	3.1	7.9	7.7
Federal Government.....	2.3	2.7	2.6	4.2	4.0
Contract construction.....	2.8	3.3	2.1	5.2	4.8
Transportation and public utilities.....	3.9	4.3	1.5	7.2	6.4
Mining.....	.7	.6	-1.0	1.2	.9

<sup>1</sup> Preliminary.

<sup>2</sup> Based on employment in thousands.

Note.—Detail will not necessarily add to totals because of rounding.

Source: Department of Labor.

needs for workers in retail trade and service occupations have been reflected in wage gains larger than those in manufacturing (Table 11). Similarly, earnings in many professions have advanced rapidly.

Although the labor force is highly mobile and able to adjust readily to substantial shifts in demand, there are still many costly barriers that workers must cross when moving among jobs and occupations. One remedy is to lower the barriers, allowing workers freer access to jobs. Another is to bring work to areas of high unemployment. The benefits and limitations of making jobs available to those living where few opportunities now exist are explored in Chapter 5.

TABLE 11.—Changes in hourly earnings of production and nonsupervisory workers on private nonagricultural payrolls, 1961 to 1968

Industry group	Average hourly earnings		Percentage change per year, 1961 to 1968 <sup>1</sup>
	1961	1968 <sup>1</sup>	
Total private nonagricultural payrolls <sup>2</sup> .....	\$2.14	\$2.85	4.2
Retail trade.....	1.56	2.16	4.8
Contract construction.....	3.20	4.38	4.6
Finance, insurance, and real estate.....	2.09	2.75	4.0
Wholesale trade.....	2.31	3.05	4.0
Manufacturing.....	2.32	3.01	3.8
Mining.....	2.64	3.34	3.4

<sup>1</sup> Preliminary.

<sup>2</sup> Total includes certain industry groups not shown separately.

Source: Department of Labor.

## *Information on Job Opportunities*

Rapid adaptation of the labor force to changing demands can be aided by timely information regarding job opportunities. The disadvantaged in particular are likely to lack such information. Recognizing this handicap, the Federal-State Employment Services in 1965 began seeking out disadvantaged workers for enrollment in training programs, for job referral, and for work counseling.

The importance of improved job information was also recognized in the 1968 Amendments to the Manpower Development and Training Act (MDTA). This legislation authorized the development of a comprehensive system of labor market information, using electronic data processing and telecommunication systems for direct contact among recruitment, job training, and placement agencies.

## *Relocation Assistance*

The cost of moving can make it difficult for low-income workers to respond to job opportunities. The 1965 Amendments to the MDTA authorized an experimental program of relocation assistance to test the value of helping disadvantaged workers in depressed areas move to places of better employment opportunity. Thus far, 13,000 workers and their families have received assistance under the program. The experience from this pilot program suggests that the benefits far outweigh the \$750 average cost of relocation.

## *Vesting and Portability of Pension Rights*

By 1980, private retirement plans will cover some 40 million workers—about three-fifths of all private nonfarm employees. Nonvested plans, in which the worker loses his pension rights if his employment terminates, not only operate inequitably against many long-service employees but also discourage mobility.

Vesting would enable the worker to retain his financial stake in his pension when he changes employers. To encourage more vesting, the Department of Labor has proposed a Pension Benefit Security Act. It would require full vesting after 10 years of service, to become fully effective 12 years after passage. At present, only about 20 percent of all workers are in retirement plans which fulfill this requirement.

Another way to overcome the restrictive effect of pension plans on mobility would be to increase the ability of employees to transfer pension credits among employers in a particular industry. This type of portability, largely found in multi-employer collective bargaining contracts, enhances mobility within industries but not across industry boundaries. In construction, multi-employer pension plans are common but generally limited to a particular city

or metropolitan area. Greater reciprocity among these plans would enhance mobility in this important sector.

### *Licensing*

State licensing provisions affecting some skilled trades and many professions restrict mobility to the extent that there is not full reciprocity among States. Electricians, plumbers, barbers, and beauticians are examples of the licensed tradesmen; physicians, dentists, lawyers, accountants, and teachers are examples of the professionals. In some cases, notably physicians, there is relatively full reciprocity. But in others, those who have licenses in one State are required to pass new examinations or to meet different special qualifications if they want to move to other States.

In principle, these requirements are imposed to protect public health or safety, or the quality of service. Yet they may serve to restrict competition, particularly in localities or States where pay scales are relatively high. Mobility could be enhanced by universal reciprocity at generally acceptable standards.

### *Discrimination in Employment*

One of the most widespread barriers to the full use of our labor force is discrimination against women and members of minority groups. Great progress has been made in reducing these and other categorical barriers to employment; Federal legislation now outlaws discrimination on the basis of race, religion, national origin, sex, or age. While the policy is now clear, a very large job of enforcement remains.

In addition, arbitrary barriers to employment may still be imposed by employers who maintain unnecessarily restrictive hiring standards as described in Chapter 5. Some unions also impose unreasonable restrictions on membership.

### *Minimum Wages*

Minimum wage laws protect the worker against the imperfections of the labor market which lead to substandard wages. Such laws may also encourage the more efficient use of labor. Although increases in the minimum wage are likely to be reflected in higher prices, society should be willing to pay the cost if this is the best way to help low-wage workers. Yet excessively rapid and general increases in the minimum can hurt these workers by curtailing their employment opportunities.

Since 1956, the Federal minimum has gone up about in line with average hourly compensation, while coverage has progressively expanded to cover low-wage industries. In considering the future rate of increase for minimum wages, careful scrutiny should be made of the possibility of adverse employ-

ment effects. The benefits of higher minimums should be weighed against alternative ways of helping low-wage workers.

## EFFICIENT USE OF MANPOWER

Responding to the expanding employment opportunities of our economy, American workers generally have accepted—and even welcomed—technological change. But there are exceptions; unions have secured management acceptance of restrictive work rules in such industries as railroads, printing, longshoring, and construction. These rules reflect a legitimate concern for job security. But where technological change does adversely affect job security, it would be preferable to avoid restrictive practices and develop solutions specifically to meet that problem. Workers can be largely compensated for the loss of particular positions and of seniority protection through such provisions as severance pay, attrition plans, and the option of early retirement for older workers. The trend of collective bargaining agreements is in this direction, but the exceptions are still costly to the economy.

### *Legal Restrictions*

Legal restrictions designed to protect health and safety may, in some cases, impose unnecessary barriers to the efficient use of labor.

For example, local building codes sometimes prevent the use of construction labor as efficiently as technology allows, according to a report of the National Commission on Urban Problems. The Commission also found that an unnecessary diversity among codes inhibits large-scale operations by contractors and manufacturers. It recommended that private and public bodies develop standards that could be accepted and applied throughout the Nation.

Another example is railroad full-crew laws affecting freight and road service in seven States. These laws reflect an approach that dates back to the era of the steam engine. Despite dieselization and modern improvements in communication, the laws remain.

### *Seasonality*

Instability of work leads to inefficient use of manpower, throwing persons able and willing to work into unemployment. Seasonal variations are a major source of such waste, particularly in construction.

More than one-fourth of all wage and salaried workers in contract construction experience some unemployment during the year. This is about double the proportion in manufacturing and other nonagricultural industries. Besides the waste of valuable manpower, seasonality leads to labor shortages during peaks of activity in particular occupations and geographical areas. A number of studies have indicated that, for most types of construction, the added costs of winter work are small and might be offset by just the savings in unemployment compensation for construction workers. More

stable employment might also moderate the sharp upward trend in hourly wages for construction workers, at the same time improving their annual incomes.

In light of these considerations, the President recently instructed Government agencies to explore the possibility of scheduling more construction in winter months. Progress in this direction by the Federal Government could serve as an example to State and local governments and to private industry.

#### MANPOWER TRAINING PROGRAMS

Training programs must be oriented toward two main objectives. The first, and probably most important in both its economic and social implications, is to assist the disadvantaged and the unemployed to acquire new skills. Such efforts present special and highly important problems, which are discussed in Chapter 5 in the context of the problem of poverty. The second objective is to help increase the supply of skilled workers and professionals to keep up with rapidly rising demand.

##### *Skilled Workers*

Federal and federally assisted training programs can make an important contribution to meet the rising demand for skilled workers in periods of high employment. The Vocational Education Act of 1963 authorized a large expansion of vocational training programs. Post-secondary day school vocational enrollments increased from 171,000 in 1964 to 501,000 in 1967, and enrollments of adults in part-time programs rose from 2.3 to 2.9 million. The total number of persons in trade and industrial programs rose from 1.1 to 1.4 million between 1964 and 1967.

Establishing and operating flexible, expanding training programs pose some difficult problems. Ideally, the pattern of training should be related to forecasts of changing demand for workers in different occupations, thus meshing the training with emerging needs. In practice, this is not easy to accomplish.

There is also danger that vocational programs, once established, may continue unchanged despite radical shifts in the demand for skills. For example, high school enrollments in vocational agriculture remained almost constant from 1964 to 1967, despite the sharp and persistent drop in agricultural work opportunities and the movement of many rural youths to other jobs. The scope of vocational education should be broadened to meet the future manpower needs of the economy. The 5 percent of total enrollees in vocational classes preparing for health and technical occupations is much too small. More training should be provided in new occupations such as automatic data processing and electronics.

In addition, skilled workers will be needed in such traditional trades as construction. There is every indication that the demand for construction in the 1970's will be of unprecedented magnitude. Success in meeting the

national target for housing recently adopted by the Congress will depend upon the availability of enough skilled workers.

### *Professions*

The demand for professionals has increased sharply. Although their number has grown at an annual rate of 4.2 percent in 1961–68, as compared with only a 2.6 percent increase in the number of production workers in manufacturing, supply has not kept pace with demand. As a result, earnings in many professions have risen at a substantially higher rate than those of manufacturing production workers.

The rise in demand for professional and technical personnel reflects numerous factors. In health care, the general rise in affluence has contributed significantly, along with Medicare, Medicaid, and the rapid increase in the elderly population. Total spending on health care rose from \$26 billion in fiscal 1960 to \$53 billion in fiscal 1968.

The great technological advances of the past decade have vastly increased the demand for such professionals as physicists, chemists, mathematicians, and engineers. Expenditures for research and development have grown rapidly. Between fiscal 1961 and 1966, the dominant factor in the expansion was Government spending for research and development, which rose at the rate of 11.5 percent a year, before slowing markedly in 1966–68. For the National Aeronautics and Space Administration program alone, the number of scientists and engineers directly involved increased from less than 11,000 in 1960 to a peak of nearly 92,000 in mid-1966. Private spending on research and development also increased at a rapid rate, growing at 8.8 percent annually between 1961 and 1967.

Newly instituted Federal programs have helped to meet the expanding demand for professional personnel. The Education Professions Development Act of 1967 gave the Office of Education authority to assist in the training of school personnel at all levels and in various occupations. Under the Health Professions Educational Assistance Amendments of 1965, about 13,500 scholarships have been awarded in medicine, dentistry, and pharmacy. A variety of fellowship, training, and grant programs is providing assistance to more than 43,000 students in 1968–69, as compared with 10,500 in 1962–63.

Despite these advances, the present programs are not adequate to meet the growing needs for trained professionals.

### *Adjusting Job Requirements*

In light of the high and growing demand for fully qualified professional personnel, the more routine or subprofessional tasks should be performed by such paraprofessionals as teacher's aides, nurse's aides, dental technicians, and engineering technicians.

The New Careers Program, administered by the Department of Labor, is helping to prepare disadvantaged adults for jobs in public and private non-profit agencies in the fields of health, education, welfare, neighborhood redevelopment, and public service. As of mid-1968, about 5,000 persons were enrolled under this program. Cooperating institutions have agreed to revise job requirements and to develop new career opportunities for subprofessional workers.

### *Future Directions for Manpower Policy*

Training programs under the MDTA have the potential for making a great contribution to price stability and high employment. Accomplishments thus far have been limited, mainly because the programs have been small relative to need. Only an average of 173,000 persons yearly have been enrolled from 1963 to 1968. In 1968, 272,000 were enrolled, equal to three-tenths of 1 percent of the Nation's labor force. Moreover, only 18 percent of the total were trained in critical skills.

The creation of a new system of adult job training proved complex. Difficulties were inherent and experimentation necessary. But after 5 years of experience, it is evident that MDTA training and assistance can help the economy make more efficient use of manpower.

The Federal Government has greatly increased its support of college students and institutions of higher education. The total funds available in both grants and loans rose from an estimated \$1.5 billion in 1962 to \$4.4 billion in 1968. Federal funds for student loans increased from an estimated \$75 million in 1962 to \$251 million in 1968. Nevertheless, there remains a need for additional support. When properly designed, loans are a particularly suitable form of aid for college students, although many youths from low-income families may require special assistance through direct grants.

Federal aid can also be useful in underwriting the costs of expanding the capacity of professional schools where training facilities are most critically short, as in medical education. And better planning of Government programs can lessen the pressure on the limited pool of professional manpower. The Federal Government directly and indirectly pays the salaries of 10 to 15 percent of all professionals. Because the supply of professionals cannot be expanded quickly, adding significantly to demand can affect salaries throughout the economy for many years.

### COMPETITION AND ANTITRUST POLICY

The prevalence of strong competitive forces in most markets of the U.S. economy reflects its vast size, the ability and willingness of businessmen to respond to new opportunities, and a long-standing commitment of public policy to promote competition—most importantly exemplified in the antitrust laws.

## *Antitrust Laws and Prices*

While antitrust action is an effective weapon against collusive price agreements, violations still occur and continuous vigilance is necessary. For example, since 1965, there have been price-fixing convictions in such diverse industries as plumbing fixtures, steel, and pharmaceuticals.

Antitrust also has a major role to play in reducing concentration. In highly concentrated industries—those in which a few firms control a large proportion of sales—price competition is likely to be less intense than it is elsewhere in the economy. Numerous studies have shown a significant relationship between high concentration and high profit rates—an indication of weak competitive pressures. Moreover, the high profits sometimes earned by firms in the less competitive industries are understandably a tempting target for large wage demands, which sometimes spread to other industries.

Furthermore, concentrated industries often maintain prices in the face of declining demand, reducing output instead. As demand fluctuates among products over time, prices may rise where demand increases, but fail to decline where demand decreases. This results in an inflationary bias, which might be substantially reduced by greater competition.

Vigorous antitrust enforcement helps to hold down prices by breaking up price conspiracies and reducing concentration. A continuing program of antitrust actions can increase competition and contribute to improved over-all price performance at high employment.

## *Mergers and Concentration*

The present levels of concentration in many industries are in large part the result of peaks of merger activity at the turn of the century and during the 1920's. Although the number of mergers in recent years has reached gargantuan proportions—1,496 major mergers of manufacturing and mining concerns in 1967 as compared to 219 in 1950—most of them involved firms in different industries rather than in the same industry. In part, this reflects the Celler-Kefauver amendment to the Clayton Act which has severely restricted combinations that might lessen competition. In 1967, 83 percent of the larger mergers consisted of purchases of firms in unrelated industries; in comparison, less than 60 percent of larger mergers between 1948 and 1953 were of this conglomerate type.

## *Reducing Concentration*

In a few major industries, concentration has been very high for many years. New approaches to reducing concentration in these industries should be examined. Competitive forces can be enhanced by modifying existing industry patterns or by promoting entry of additional competitors.

One approach would be to seek court decrees to promote competition by such measures as altering distribution and patent licensing practices. In

industries of critical economic importance, the appropriate remedy may be the divestiture of parts of the operations of the largest firms to create new competitors.

A second approach is to adopt measures to channel merger activity in directions that would increase competition. Mergers could have a healthy impact on concentration if acquiring firms of very large size were barred from purchasing the leading firms in other concentrated industries. The major route for entry into a concentrated industry by a very large firm then would be to build new capacity or to buy an existing smaller firm. When a very large firm buys a small firm in a concentrated industry, it has the resources to expand that firm's capacity and to try to increase its share of the market. Such a merger can infuse new vigor and ideas into that market.

There is also need to review certain provisions of the tax laws which provide incentives for mergers. Consideration should be given to modifying the statutes so as to make the tax laws more consistent with the objectives of antitrust policy.

An effective program to deal with very high levels of concentration may require new legislation, carefully drafted to avoid either penalizing economic efficiency or placing unnecessary restrictions on the freedom to respond to competitive opportunities. With these two limitations, measures to strengthen competitive pressures in a number of highly concentrated industries could further increase the contribution of antitrust policy to price stability.

## LEGAL RESTRICTIONS ON COMPETITION

In spite of the Government's commitment to the strengthening of competitive markets, some existing laws may weaken competition. Most of these laws were adopted during the 1930's to relieve the especially serious impact of the depression on small firms in the distributive trades.

### *Resale Price Maintenance*

Major examples of these depression-born laws are the resale price maintenance statutes still in effect in 22 States. These "Fair Trade" acts permit a manufacturer to require that all the retailers in a State observe a minimum resale price for that manufacturer's trademarked products. Since these products generally move in interstate commerce, the practice rests on exemptions from Federal antitrust laws granted under the provisions of the Miller-Tydings Act (1937) and the Maguire amendment (1952).

Resale price maintenance contracts are used mostly in the sale of drugs, cosmetics, appliances, and liquors. A survey by the Department of Justice in 1956 showed that prices were 19 to 27 percent higher on fair-traded items in States with resale price maintenance laws than in other States. Some estimates place the annual cost to the consumer of resale price maintenance at \$1.5 billion.

One effect of resale price maintenance is to shift the focus of competition into less desirable forms. Retailers compete by providing more extensive consumer services, thereby increasing business costs. Manufacturers often set resale prices at levels providing generous markups to retailers, in order to induce them to favor the sale of their products.

The principal objective of resale price maintenance is to protect smaller concerns from their larger competitors. The prohibition of predatory practices is a valid objective of public policy. In practice, however, lower prices reflecting greater efficiency and lower costs cannot be called predatory. Moreover, there is no evidence that the efficient small retailer needs such special protection, which can freeze an inefficient market structure.

For these reasons, the Administration has consistently opposed legislation designed to extend resale price maintenance. Indeed, it is hard to see a continuing justification for the existing laws in today's prosperous economy.

### *Robinson-Patman Act*

The Robinson-Patman Act is another important Federal law intended to protect the small from the large. The Act attempts to prevent chains, mail-order houses, and other huge buyers from extorting preferential price concessions from suppliers.

Although public policy should be concerned with preventing improper use of the advantages conferred by sheer size, some evidence indicates that the Act has had the unintended effect of accentuating price rigidities in some markets. A seller may refuse to bargain on price with an individual customer by contending that under the law any concession granted to one buyer would have to be made uniformly available to all others. The law may conflict with the development of more efficient methods of distribution, such as integrating wholesale and retail functions or dispensing with independent brokers. By requiring proportionally equal treatment in certain promotional practices, the Act has discouraged experimentation with marketing techniques. It has been interpreted to prevent sellers from charging different prices in widely separated geographic markets.

A careful reappraisal of the Act might suggest ways to focus its application more sharply on those particular forms of price discrimination that constitute a truly serious threat to competition.

### IMPROVING CONSUMER INFORMATION

The effectiveness of price competition in consumer markets depends partly on the purchasing skill of the consumer. Dependable product and price information are needed to allow consumers to evaluate and compare the relative costs and merits of the enormous variety of goods and services offered for sale.

### *Legislative Achievements and Proposals*

In the last two Congresses, 20 bills protecting the consumer were enacted. Two of the most important were the Truth-in-Packaging and the Truth-in-Lending Acts.

The Truth-in-Packaging Act, signed in November 1966, recognizes that the bewildering multiplicity of package sizes for common household products makes price comparison difficult. While the enforcement provisions are weak, the Act takes important steps toward remedying the situation. One provision encourages interested industry groups, with the aid of consumers and government agencies, to develop voluntary standards to limit the number of package sizes. Another provision requires standardization of the location and form of the quantity statements on packages.

The 1968 Truth-in-Lending Act requires that the finance charge on consumer credit transactions be expressed in terms of a simple annual rate. At present such charges are often stated in ways that make it difficult for the consumer to know the true cost of credit.

Among the legislative proposals remaining from the previous Congress are those relating to deceptive sales techniques, which in the home improvement field alone are estimated to cost the consumer over \$500 million annually. The Deceptive Sales Act, passed by the Senate but not the House in 1968, would give the Federal Trade Commission authority to obtain court orders to stop fraudulent and deceptive practices promptly. Other proposals would permit cancellation without penalty for 3 business days after the signing of a door-to-door sales contract and would authorize a Federal Trade Commission study of the home improvement industry.

Sometimes selling practices themselves may restrict consumer choice and lead to higher prices. Often when a promotional practice is introduced by one seller, the response from competitors is not to lower prices but to introduce the same type of promotion. Trading stamps illustrate the contagious nature of sales techniques. Although many buyers can choose readily between stores that offer stamps and those that do not, other buyers can do so only at substantial inconvenience. In fact, almost half of all food sales in 1963 were made by merchants offering trading stamps. Therefore consideration should be given to legislation that assures consumers a choice between stamps and an equivalent cash discount.

### *Product Testing*

Steps can also be taken to provide more complete and reliable product information. Advertising is a major source of consumer information, but it needs to be supplemented. The purpose of advertising is to stress the desirable qualities of particular items, not to set forth an objective appraisal of the relative merits of competing products.

A few independent groups now test products and publicize their results, but their ability to do so is limited partly because their financial resources are not large. These activities could be supplemented by making available

to the public the test data which various agencies of the Federal Government have accumulated in connection with their procurement activities. As a beginning, the Department of Health, Education, and Welfare and the Veterans Administration have recently announced that they will release the results of future product tests.

## REGULATED INDUSTRIES

Electric power, most communications, natural gas, banking, securities markets, insurance, and most public transportation are subject to detailed regulation by Federal, State, or local agencies. The economic importance of these sectors is great. They account for about 9 percent of national income, and their prices and services affect many production and investment decisions throughout the economy.

Problems naturally develop in regulated areas where technology and demand have changed rapidly. Existing regulatory practices need continuing review to determine whether established measures and institutions are efficiently responding to changing technology. Moreover, regulatory issues increasingly span the jurisdictions of several Federal agencies or cut across the authority of Federal-State-local agencies. Some of the areas where careful review might be most rewarding are identified below.

### *Utilities*

Public utilities, especially electric and telephone companies, have made impressive economic gains through high rates of productivity and declining relative prices. Notwithstanding these gains, utilities might contribute more to price stability if productivity improvement or cost savings were more promptly translated into lower rates, with due regard to preserving the incentives for increased efficiency and the ability of the companies to raise new capital.

*Electric Power.* The two major characteristics of the electric power industry in the last decade have been its rapid growth, now at 7 percent a year, and the lower unit costs made possible by advances in technology, increased interstate system coordination, and economies of scale. These complementary trends have permitted significant reductions in rates charged consumers, despite increases in many costs to the industry. These trends should continue in the next decade; the National Power Survey estimated that cost savings of as much as \$11 billion annually (measured in 1962 dollars) are possible by 1980, if full advantage is taken of technological progress and market potential, and if closer coordination of planning and operations among the diverse ownership segments of the industry is achieved. Regulatory programs must be reevaluated periodically and new programs designed to ensure that these potential cost savings are fully realized and promptly reflected in rates.

*Natural Gas.* This important fuel has almost tripled its share of the energy market in the last 3 decades and now supplies about one-third of the Nation's energy requirements. Natural gas is subject to comprehensive Federal, State, and local regulation. The Federal Government regulates entry into interstate markets, wholesale rates, and conditions of service and safety. In the 1960's, Federal regulation has resulted in relatively stable rates, in contrast to the steep price increases that marked the preceding decade. The new concept of setting a common price schedule for natural gas sales in each producing area offers the expectation of an improved regulatory procedure.

Recently, rising costs—particularly taxes and bond interest rates—have caused natural gas companies to file a rash of applications for rate increases. Some applications also assert that higher rates are necessary to stimulate exploration for, and development of, future reserves. These contentions must be recognized and dealt with expeditiously. Specifically, careful scrutiny must be given to costing formulas, evolving technology, and to the future adequacy of supply.

### *Securities Markets*

A careful review of securities markets revealed several problems in the thriving mutual funds industry. In particular, a provision of the Investment Company Act prohibits dealers from reducing sales charges fixed by the mutual fund underwriter. Many mutual funds have commission charges considerably higher than those on most other security transactions.

In addition, stock exchange rules prescribe uniform minimum brokerage commissions. The Securities and Exchange Commission is currently investigating this practice to see whether such limits on price competition can be eliminated or modified without damage to security markets.

### *Transportation*

The sector that appears to offer the broadest opportunities for further regulatory improvement is transportation. Regulation was originally imposed on railroads about 80 years ago, when competition from other modes was minimal, to protect shippers and travelers from discriminatory treatment. With the development of new modes of transportation such as pipelines, trucking, and air carriers, the general pattern of railroad regulation has been extended to cover them.

But technological change, rising consumer incomes, and extensive public investment in transport facilities have led to greatly increased competition among different forms of transportation. In the past two decades, some regulatory decisions have insulated existing carriers and their patterns of service and rates from that invigorating competition.

*Competition.* Statutory exemptions from regulation in water and motor transport cover about 87 percent of the ton-miles moved on inland waterways

and 64 percent of intercity ton-miles moved by truck. Free market decisions involving rates and the amount and quality of service have worked satisfactorily in these exempted areas over a long period. Current antitrust laws protect against improper carrier conduct.

Reliance on competition permits carriers to adjust rates freely. Regulators, in contrast, have often required firms to keep rates up to the level of "fully distributed costs," which reflect an arbitrary allocation of overhead. Air, truck, and inland water carriers do not have the large indivisible inputs characteristic of railroads and pipelines, such as rights-of-way and terminals. Thus railroads have relatively high fixed costs, and if overhead must be allocated to each traffic unit on a rigid basis, the calculated average costs and rate schedules may differ markedly from the variable expenses of additional traffic. Minimum rates based on these average costs can divert traffic from railroads even when they could offer the least costly mode of transportation.

A recent specific case illustrates this problem. The Interstate Commerce Commission denied a request by the railroads to reduce their rate for handling ingot molds to a level lower than that charged by the competing barge-truck service. The proposed rate was below the railroads' fully distributed costs, but above their marginal costs. On appeal, the Supreme Court held that the Commission had the authority to determine which cost base to use. The decision thus left it to the Commission to base its rulings on marginal cost criteria when it thought appropriate.

To the extent that minimum rate regulation is continued, marginal costs rather than fully distributed costs would most closely approximate the pattern which a competitive market would produce. This principle, if generally applied, would result in a much more efficient distribution of transportation resources and in lower costs to users of transportation services.

*Entry.* A better use of our potential transportation resources can also be achieved by lessening regulatory barriers to entry—particularly for trucks. A motor carrier now requires a specific grant of operating authority, a procedure instituted in an earlier period of overcapacity. The problem today is to serve a growing volume of traffic, which has expanded since 1961 at an annual rate of 4 percent as measured by intercity ton-miles.

The Interstate Commerce Commission has issued over 100,000 grants of operating rights to motor carriers, mostly at the time regulation was instituted. At present, securing new rights is difficult; moreover, some existing rights are restricted to specific commodities, routes, direction of movement, and territory.

## GOVERNMENT PROCUREMENT

The Federal Government, the largest single buyer in our economy, purchased \$54.7 billion of goods and services from the private sector in 1967. Consequently, the manner and care with which the Government carries out its purchases have a significant impact not only on the prices it pays but on other prices throughout the economy.

### *Competitive Procurement*

Because competition normally works to improve quality and keep prices in line with costs, the Government has long relied on competitive bidding whenever possible. In fiscal 1968, about three-quarters of the dollars spent by the General Services Administration, the chief purchaser of general supplies for the Government, involved formal bidding; another fifth involved other procurement methods that stressed price competition. Currently 82 percent of all Government purchases are made by the Department of Defense. Since many of these expenditures involve the development and production of sophisticated weapon systems, they are less suited to conventional price competition. In fiscal 1968, only 38 percent of defense outlays—up from 33 percent in fiscal 1961—utilized formal bidding or other methods stressing price competition. However, varying degrees of competition existed for a substantial portion of the remainder of defense procurement.

### *Negotiated Procurement*

Competitive procurement is most difficult to achieve for specially built hardware, such as major defense systems, for which the Federal Government is the only buyer. When competition cannot be relied upon to hold down costs, contracts providing incentives for cost reduction are desirable. Fixed-price type contracts, in which the contractor shares in any cost reduction or cost escalation, have increased from 58 percent of all defense purchases in fiscal 1961 to 78 percent in fiscal 1968. Cost-plus-fixed-fee contracts, which provide less incentive for cost reduction, have dropped from 37 percent of the dollar volume to 11 percent over the same period.

Total Package Procurement, a major procurement innovation of the 1960's, has extended competition and permitted more fixed price contracts. It requires a binding commitment from the contractor on as much of the production program as is feasible at the time of the initial award. This is a significant departure from the earlier practice of conducting design competitions for development followed by cost reimbursement production contracts with the developer. The new approach emphasizes the use of performance specifications and provides tightened control over design and contract changes, thereby reducing expensive modifications. Since the contractor is committed to cost and performance figures for production units before detailed design begins, he has a strong motive to design for economical production, reliability, and simplicity of maintenance.

### *Single Source Procurement*

Unfortunately, it is not possible to introduce price competition into all purchasing. For example, Total Package Procurement is unsuited for pro-

grams where needs or technology are changing rapidly, since technical uncertainties cannot be identified in detail before major work starts.

From the point of view of price stability, the least desirable situation is the case of a "sole source" supplier, operating under a cost reimbursement (rather than fixed price) contract. In fiscal 1968, 14 percent of the dollar volume of defense procurement was in this category.

Such awards often reflect the special experience of one firm as well as the uncertainties of technology. For example, only one particular firm is considered to have the capability to develop the Sentinel antiballistic-missile system. Therefore, the Department of Defense will of necessity procure from one source for this multibillion dollar program for some time. A large number of subcontractors are involved, however; and as soon as possible, major items will be broken out and procured separately under competitive conditions.

Great progress has been made in recent years in improving procurement methods, but further progress is essential for improved price performance. Efforts to encourage competition and to develop new methods of procurement must be maintained.

## AGRICULTURE

Three main problems continue to confront agricultural policymakers. Returns to the labor of some farmers and their workers are low, particularly on smaller farms. Price fluctuations are severe as a result of weather, livestock production cycles, and international developments. And price instability is compounded by excess capacity and a consequent chronic tendency to produce more of certain major crops than the market can readily absorb at reasonable prices.

### *Achievements of Agricultural Policies*

In broad perspective, past agricultural programs have been successful for commercial farmers. They have made it possible to eliminate the burdensome surpluses of 1960. They have provided higher and more stable prices than would have existed otherwise and thereby helped moderate fluctuations in farm income. They have reduced risks associated with farm planning, permitted more efficient business management, and encouraged a substantial increase in the capital investment per worker. These factors in turn have made possible gains in labor productivity of 175 percent since 1950.

### *Changing Farm Structure*

Profound changes have occurred in the structure of the farm economy in the 35 years since major farm price legislation was first introduced. The number of farms has been halved. Total farm output and average farm size have more than doubled. Differences in output per farm have become pro-

nounced. Fifteen percent of the farmers—those grossing \$20,000 or more annually—marketed two-thirds of the value of the 1967 farm output. More than half of the farmers accounted for less than 7 percent of the total.

Farm income is a progressively less important part of the total income of many operators of smaller farms. In 1967, farmers selling less than \$2,500 in farm products received net farm incomes averaging only \$1,018 but had average off-farm incomes of \$5,681. Nevertheless, there are many farm families without such off-farm income whose total incomes fall below the poverty line.

### *New Directions for Policy*

In light of the changing structure of U.S. agriculture, proposals have been advanced to modify price support programs. A reasonable limit on the amount any one farmer could receive from Government payments might provide annual savings approaching \$200 million. Any such program, however, would have to be carefully designed to avoid major administrative difficulties and to preserve the incentives for acreage limitations. A Department of Agriculture study indicates that, in recent years, farmers with gross annual incomes at or above \$20,000 earned more for their labor and capital than they would have with the same resources in the nonfarm sector. This suggests that these highly efficient farmers have a lessening need for economic aid. On the other hand, those with small farms derive less than 20 percent of their income, on the average, from farm sales. Hence some gradual restructuring of farm price supports to bring market demand and supply into closer balance would have little effect on their income, and payment limitations would not apply to them.

A better balance of equity among large farms, small farms, and consumers would be achieved if more market-oriented price supports were accompanied by: an expansion of the 1965 Cropland Adjustment Program (providing for voluntary land retirement); more job training programs in rural areas; continued emphasis on community resource development; and more effective income maintenance programs for farm families in poverty (see Chapter 5).

A restructuring of farm programs along these lines could encourage large farmers to continue to increase their investments and make full use of the opportunities constantly being opened by new technology. They would also have freedom to exercise the option of conserving land resources until market competition made profitable cultivation possible.

### INTERNATIONAL TRADE AND PRICE STABILITY

Price competition is enhanced by the availability of imported products. During periods of high employment, increased import competition helps to offset the decline in the intensity of competitive behavior among domestic producers which accompanies high over-all demand. Rising imports also help to avoid the development of bottlenecks and shortages when demand is

straining domestic capacity. They thus make a vital contribution toward the moderation of inflationary tendencies.

There is no doubt that prices in industries subject to strong import competition would have risen faster if such competition had been restricted. For example, steel prices increased by 35 percent between 1953 and 1961 when imports were small, but only 7½ percent between 1961 and the end of 1968 when growing world capacity led to an expansion of imports. There is clear evidence that steel producers have been especially wary about raising prices for product lines subject to heavy import competition, such as wire and wire products, or hot rolled sheet.

To the extent that less expensive imported items enter into further processing or manufacture, they reduce costs and permit lower prices for final products. Thus the availability of imported yarn and fabrics, by reducing the costs of our apparel manufacturers, permits them to compete more effectively against apparel imports. The competitiveness of our machinery manufacturers in export markets is similarly enhanced by their ability to obtain steel—imported or domestic—at prices lower than they would have to pay if imports were restricted.

### *Impact on Domestic Industries*

The increased flow of imports entails certain costs that must be weighed against the benefits. It has cut into the markets of some important industries (notably steel, textiles, and footwear) and a few agricultural sectors. This has resulted in pressures for import restrictions, usually in the form of quota limitations. An international arrangement controlling imports has been in effect for cotton products since 1962, and a current issue is whether to extend this type of arrangement to textiles made from wool and synthetics. Quotas have been imposed on agricultural imports, usually to prevent the growth of Government stockpiles. For a number of products, informal arrangements limiting imports are in force or are being considered as a more flexible and less onerous instrument than formal quotas.

While imports are an important factor in a number of domestic markets, they have not prevented expansion of the industries most affected. Steel, textile, and apparel output has increased since 1960, and after-tax profits have risen in all three industries. The rate of return on equity for these industries has also improved considerably, although it remains below the average for all manufacturing—as it has for many years.

It is important to emphasize that increased imports in these and other industries reflect, in part, long-run changes in trade patterns resulting from the natural development of the industrial structures of the United States and its trading partners. The dynamic U.S. economy need not and should not be insulated from these changes. The crucial issue is not whether barriers to imports would increase employment and sales in the industries affected, but rather whether our economy is offering ample employment and investment opportunities, at the same or better conditions, in other

pursuits. If these interindustry shifts impose transitional costs, such burdens should be shared and alleviated by Federal adjustment assistance. Furthermore, fundamental shifts in efficiency should be carefully distinguished from special situations such as dumping practices and export incentives given by other nations. Some of these situations, as well as adjustment assistance, are discussed in Chapter 4 along with other measures to ensure the two-way nature of trade by keeping world markets open and fair.

### *National Security and Trade*

A valid case for protecting a key industry can be made if national security would be seriously threatened by a sharp increase in imports. The national security rationale underpins the mandatory oil import program, which imposes limits on petroleum imports. It may be desirable to reexamine the security rationale to determine if the present administration of the program best meets the objective. Some changes may be possible which, while preserving essential security objectives, would permit greater flexibility and ensure an economical supply of petroleum feedstocks for the petrochemical industry.

## VOLUNTARY RESTRAINT IN PRICES AND WAGES

The forces exerting upward pressures on wages and prices in a high employment economy are broad and impersonal. The responses of wages and prices to these pressures, however, are expressed through a multitude of separate decisions by employees and employers, by sellers and buyers.

### ROLE OF PRIVATE DECISIONS

These decisions must be made within the constraints imposed by the market, constraints which operate on even the largest businesses and the strongest unions. Nevertheless, major companies in highly concentrated industries have substantial discretion in their price and wage decisions, as do many unions in the determination of wages. The way this discretion is exercised by the majority of business executives and labor leaders can have a substantial impact on the trends of prices and wages, even though no single business or union can by itself have a decisive influence.

This imposes a grave responsibility on decisionmakers who have discretionary market power. Since the economic consequences of private price and wage decisions bear so importantly on the public welfare, it is appropriate for Government to point the way in which these individual decisions can best serve the public interest.

### STANDARDS FOR DECISIONS

The Government has worked to evoke a general awareness of the importance of price and wage restraint among business, labor, and the public. These efforts date back to the Economic Reports of President Eisenhower

in the late 1950's. A more explicit formulation was proposed in the Council's 1962 Annual Report in the form of the wage-price guideposts. In subsequent Reports, these guideposts evolved gradually—a process described in detail in the Council's 1967 Annual Report.

As initially set forth in 1962, the guideposts stated:

The general guide for noninflationary wage behavior is that the rate of increase in wage rates (including fringe benefits) in each industry be equal to the trend rate of over-all productivity increase. . . .

The general guide for noninflationary price behavior calls for price reduction if the industry's rate of productivity increase exceeds the over-all rate—for this would mean declining unit labor costs; it calls for an appropriate increase in price if the opposite relationship prevails; and it calls for stable prices if the two rates of productivity increase are equal.

The guideposts were never intended to apply in highly competitive sectors where market forces determine prices and wages in an impersonal fashion. They are applicable to markets in which discretionary power exists. Even in these markets, short-run exceptions have always been recognized when changes in relative prices and wages are necessary to facilitate shifts in the use of labor and capital, or where substandard wages exist.

#### APPLICATION OF STANDARDS

Between 1961 and 1965, decisionmakers with discretionary power generally conformed to the pattern envisaged by the guideposts. There were occasional departures, however. In particular, some industries with higher-than-average productivity gains did not reduce prices as unit labor costs fell.

The extent to which the satisfactory performance was enhanced by the efforts of the Administration to urge the observance of the guideposts cannot be precisely assessed. But the history of key wage and price decisions during this period indicates that these efforts did exert a distinct and significant influence.

The blemished price-wage record of the past 3 years reflects primarily an excessive growth of demand. Indeed, the initial departures from the path of price and cost stability were concentrated in farm products, raw materials, and services where guideposts have little, if any, applicability. The same forces also influenced price and wage decisions in areas of discretionary market power. Once consumer prices started to move up sharply, increases in compensation no larger than the productivity trend would not have led to any improvement in real income. Workers could not be expected to accept such a result, particularly in view of the previous rapid and consistent rise in corporate profits.

Recognizing this situation, the Council, in its 1967 and 1968 Reports, did not suggest that wage increases should be limited to the trend growth of productivity. It did, however, continue to urge maximum possible restraint in both wage settlements and price adjustments, and it continued to maintain the validity of the basic productivity principle for long-run price stability.

With wage increases substantially in excess of productivity, it was also recognized that production costs in many industries would rise and that some price adjustments were inevitable. At the same time, with profits generally at a high level, many industries were in a position to absorb increases in labor costs either wholly or in considerable part. The Administration therefore continued to urge business executives to avoid or minimize price increases.

This stress on the economy-wide consequences of discretionary price and wage decisions has served an important educational role in addition to its direct effects on prices and wages. The discussion of standards for prices and wages has focused the attention of business, labor, and the public on the inflationary results of individual actions that add up to demands for income in excess of what the economy can produce. Awareness of this proposition has spread among key decisionmakers in both the business and labor communities in recent years.

#### FUTURE ROLE OF COOPERATION

The cooperation of labor and business in the observance of voluntary standards of price and wage behavior is an essential part of a full program to combine high employment and reasonable price stability. Such cooperation must be viewed as a supplement to appropriate fiscal and monetary policy and to measures for improving the efficiency of the economy.

The task immediately ahead is to make significant progress toward restoring price stability during 1969. The public and private policies essential to this end are discussed in Chapter 1.

Once this has been achieved, however, the essential task for the longer run will still remain. Mandatory price and wage controls are no answer. Such controls freeze the market mechanism which guides the economy in responding to the changing pattern and volume of demand; they distort decisions on production and employment; they require a huge and cumbersome bureaucracy; they impose a heavy and costly burden on business; they perpetrate inevitable injustices. They are incompatible with a free enterprise economy and must be regarded as a last resort appropriate only in an extreme emergency such as all-out war.

Better ways must be devised of establishing standards for voluntary restraint, and for eliciting cooperation from those who enjoy discretionary market power. But if voluntary restraint is to be effective, better means must be found of focusing the attention and eliciting the cooperation of all private groups concerned—business, labor, the public—in dealing with the

issue of maintaining reasonable price stability at high employment. The task will not be easy since it requires that each group accept some sacrifice of its apparent short-run interest in order to serve its own and the public's long-run interests.

In the past, neither labor nor business played a major role in the development of the guidepost approach. In the future, effective cooperation is much more likely if those to whom the standards will apply participate in their development. Persuasion can be helped by representation.

In view of such considerations, the President instructed the Cabinet Committee on Price Stability to: "Work with representatives of business, labor, and the public to enlist cooperation toward responsible wage and price behavior . . ."

The institutional arrangements for increased business and labor participation can take many forms. This past year, the Labor-Management Advisory Committee has begun the dialogue necessary to develop standards that business and labor leaders might be willing to accept jointly. The development of standards by such a cooperative effort would strengthen the educational role of voluntary restraint and increase its effectiveness.

It is essential that the system remain on a voluntary basis. The principal sanction consistent with voluntary restraint is the force of public opinion. This means that decisions which significantly threaten the public interest must be spotlighted. Since many wage and price decisions are complicated and difficult to analyze, some competent authority must call attention to flagrant departures from standards of responsible decisionmaking. Unpleasant as such a task may be, it is inescapable. The precise way in which this task is carried out is less important than public acceptance of the necessity, equity, and reasonableness of the procedures used to review price and wage decisions.

## CONCLUSION

This chapter has reviewed some of the programs which may improve the ability of the economy to maintain reasonably stable prices at high levels of employment. It has also reviewed the contribution that can be made by voluntary cooperation toward price and wage decisions consistent with the public interest. Some conclusions emerge clearly.

It is not inevitable that pressures on labor supply should begin to appear when unemployment falls below 4 percent. It is not inevitable that wage increases should substantially exceed productivity gains, and that prices should begin to rise rapidly, as the economy reaches high employment. It is not inevitable that price stability should be restored only through the wasteful remedy of repeated doses of economic stagnation and high unemployment.

But to meet the challenge, the Nation must move ahead vigorously and imaginatively on many fronts. Both labor and product markets require nu-

merous structural improvements, and voluntary restraint must make an even greater contribution than in the past.

The task of reconciling price stability with high employment cannot be accomplished by Government alone, or by business alone, or by labor alone.

It requires clear comprehension by all groups of the overwhelming importance of this goal.

And it requires an awareness of the bleakness of the alternatives: either achieving stability by sacrificing high employment or realizing high employment by acquiescing in persistent inflation. We cannot, and need not, accept either of these alternatives.

## Chapter 4

# The International Economy

**I**N THE PAST TWO DECADES, enormous progress has been made in building a closely knit international economy. Remarkable growth in the volume of international commerce has gone hand in hand with sustained world prosperity; each has contributed to the other. At times, deep and obvious strains in the international monetary system have imperiled this progress, but these financial difficulties have been weathered without a serious setback in economic growth or world trade.

The world economy emerged from the Second World War in a gravely weakened state, with many countries suffering severely from war damage. International trade was disrupted, and exchange controls and bilateral trading arrangements were the order of the day. However, the recuperative strength of the European nations, assisted by U.S. aid, resulted in rapid economic recovery.

During the 1950's, the increasingly prosperous countries of western Europe liberalized trade and capital movements substantially. Meanwhile U.S. capital exports promoted economic growth abroad, and our balance-of-payments deficits contributed to a desirable expansion of world monetary reserves.

However, by the end of the 1950's, U.S. deficits were beginning to cause concern. A nagging question was raised: Did the international monetary system require continuous U.S. deficits and an intolerable, persistent weakening of the reserve position of the United States if serious reserve inadequacies for other countries were to be avoided?

The growth of world trade and income has continued—indeed, has accelerated—during the 1960's. But there have been periodic monetary disturbances associated with expected or feared realignments of exchange rates. While financial officials have shown wisdom and ingenuity in modifying and strengthening the international monetary system, important problems remain. Recent major financial disturbances have emphasized the need for further evolution to insure that the system can continue to support growing world trade and income.

This chapter briefly reviews the growth of world trade and output and some of the key policy issues regarding our trade relationships with the developed and less developed countries. The review is followed by discussion of international financial problems and by analysis of several current proposals designed to strengthen the international monetary system.

## ECONOMIC GROWTH AND WORLD TRADE

In the years since the Second World War growth has come to be accepted as a normal feature of the world economy. It is easy to forget that this was not the case in earlier periods. The depression years of the 1930's present a particularly sharp contrast. But by any historical comparison, the economic progress of the last 20 years is unprecedented.

World income has more than doubled since 1950. In the fifties, growth was especially rapid in the western European countries, while in recent years the United States has grown more vigorously (Table 12). Japan has experienced rapid and sustained growth throughout the period.

With their more rapid population growth, the less developed countries, taken together, have experienced a slower growth of per capita income than have the developed countries, even though total income has grown at about the same rate in both groups of countries. Growth of per capita income has varied widely among the less developed countries, in recent years ranging from high rates for Iran, Korea, Taiwan, and Thailand to virtual stagnation or even decline for some parts of Asia and Latin America.

### TRADE AND TRADE BARRIERS

The rapid growth of recent decades has contributed much to the increase in world trade (Table 13). A continuing reduction in trade barriers has

TABLE 12.—*Growth of gross national product in developed and less developed countries, 1950–67*

[Percentage change per year]

Region and country	Total real GNP			Per capita real GNP		
	1950 to 1955	1955 to 1960	1960 to 1967	1950 to 1955	1955 to 1960	1960 to 1967
Developed countries.....	4.7	3.4	4.9	3.5	2.2	3.7
United States.....	4.3	2.2	4.7	2.6	.5	3.3
Europe <sup>1</sup> .....	5.0	4.4	4.2	4.3	3.6	3.2
EEC <sup>2</sup> .....	6.3	5.3	4.6	5.5	4.4	3.6
Other countries <sup>3</sup> .....	6.2	6.1	7.7	4.4	4.6	6.3
Japan.....	4 7.7	9.8	10.4	4 6.2	8.8	9.3
Less developed countries <sup>4</sup> .....	4.7	4.5	5.0	2.8	2.2	2.5
Latin America.....	5.1	5.0	4.6	2.3	2.1	1.7
Near East <sup>5</sup> .....	(?)	5.9	6.4	(?)	3.4	3.9
South Asia.....	3.4	4.2	4.3	1.3	2.1	1.9
East Asia.....	(?)	3.8	5.2	(?)	1.2	2.5
Africa.....	(?)	(?)	3.6	(?)	(?)	1.3

<sup>1</sup> Excludes Spain, Greece, and Turkey.

<sup>2</sup> European Economic Community (EEC) consists of Belgium, Luxembourg, France, Germany (Federal Republic and West Berlin), Italy, and Netherlands.

<sup>3</sup> Consists of Canada, Australia, New Zealand, South Africa, and Japan.

<sup>4</sup> Change from 1952 to 1955.

<sup>5</sup> Estimates based on countries for which data are available.

<sup>6</sup> Includes Greece and Turkey.

<sup>7</sup> Not available.

Note.—Data exclude U.S.S.R., other East European countries, Mainland China, and Cuba.

Source: Agency for International Development.

TABLE 13.—*Growth of world exports, 1952-67*

[Percentage change per year]

Region and country	1952-53 to 1959-60	1959-60 to 1966-67	1952-53 to 1966-67
World total.....	5.7	8.1	6.9
Developed countries.....	6.2	8.8	7.5
Industrialized countries <sup>1</sup> .....	6.5	8.9	7.7
Other developed countries <sup>2</sup> .....	3.7	8.0	5.8
Less developed countries.....	4.1	5.9	5.0
Latin America.....	2.3	5.1	3.7
Other Western Hemisphere.....	3.1	3.5	3.3
Middle East.....	9.4	8.3	8.8
Asia excluding Japan.....	4.2	4.0	4.1
Africa excluding South Africa.....	3.4	7.8	5.6
Other countries.....	7.3	6.1	6.7
By type of export:			
Selected exporters of manufactures <sup>3</sup> .....	5.3	15.7	10.4
Selected oil exporters <sup>4</sup> .....	9.7	8.2	8.9
Other less developed countries.....	3.0	4.6	3.8

<sup>1</sup> Includes United States, United Kingdom, industrial Europe, Canada, and Japan.<sup>2</sup> Includes other Europe, Australia, New Zealand, and South Africa.<sup>3</sup> Includes Israel, Hong Kong, Korea, and Taiwan.<sup>4</sup> Includes Iran, Libya, Saudi Arabia, Venezuela, and Kuwait.

Note: Data include Yugoslavia, but exclude U.S.S.R., other East European countries, Mainland China, and Cuba.

Source: International Monetary Fund.

also stimulated trade. As a result of six multilateral trade negotiations within the framework of the General Agreement on Tariffs and Trade (GATT), levels of protection have been repeatedly lowered during the past 20 years. As the staged tariff reductions negotiated during the recent Kennedy Round are completed during the next 3 years, this downward trend will continue. Even after these reductions, tariffs will remain a significant barrier to trade and further efforts will be required to reduce them.

### *Nontariff Barriers*

As tariffs have been reduced, other barriers to trade have increased in relative importance. Nontariff barriers have been adopted for a variety of reasons. For example, some import quotas are surviving remnants of supposedly temporary restrictions imposed by certain countries during periods of balance-of-payments difficulties, as permitted under the rules of the GATT. Other barriers result from domestic laws aimed at protecting consumers, such as sanitary and health regulations. Government procurement policies discriminating in favor of domestic producers are another form of nontariff barrier and are at times a serious impediment to international competition for government contracts.

While protection on industrial goods has been reduced in recent years, restrictions on agricultural trade, including tariffs, have risen. These barriers are of particular concern to the United States because they have proven to be a major hindrance to U.S. agricultural exports.

The GATT rules are interpreted as permitting a country to exempt exports from indirect taxes and to impose on imports a charge equivalent to these indirect taxes. Countries such as the United States that rely heavily on income or other direct taxes may suffer a disadvantage, since similar "border adjustments" are not permitted for direct taxes. This urgent problem is under intensive discussion with our trading partners.

Work on other nontariff barriers is going forward in the GATT. Continuing and concerted efforts are necessary both for the United States and for its trading partners. Meaningful negotiations require that the United States as well as foreign countries be prepared to make concessions.

The barrier maintained by the United States that is of greatest concern to our trading partners is the "American Selling Price" provision. Under this practice, applicable to certain benzenoid chemicals and a few other goods, tariffs are based on the prices of domestic products rather than actual prices of imports.

During the Kennedy Round, conditional agreement was reached for the United States to eliminate this provision, in return for commitments by others to undertake additional reductions in tariffs on chemicals. In addition, Belgium, France, Italy, Switzerland, and the United Kingdom agreed, as part of the package, to modify certain of their nontariff barriers. Legislation to eliminate the American Selling Price provision would permit this significant agreement to be carried out.

### *Adjustment Assistance*

The Trade Expansion Act of 1962 provided for adjustment assistance to those injured by tariff reductions. It recognized that, because the gains from trade are widely distributed to the consuming public, the Nation as a whole should share the costs of adjustment associated with trade liberalization. In practice, however, the criteria of the Act have proved too rigorous. In no actual case has it been possible to demonstrate, as required, both that tariff reductions have been the major cause of an increase in imports and that the increase in imports has been the major cause of serious injury to an industry, firm, or group of workers. Legislative modification of these criteria is required in order to establish an effective program of adjustment assistance.

## LESS DEVELOPED COUNTRIES

International trade and capital transfers have made important contributions to the growth of many less developed countries during the postwar period, and they will have a major role to play in the future.

As shown in Table 13, less developed countries have not shared fully in the growth of world trade. Apart from a few countries which export manufactured goods or petroleum, exports of the less developed countries

have grown only about half as rapidly since 1952 as those of developed nations.

Most of the less developed countries depend heavily on export earnings from the sale of primary products. These products are subject to marked year-to-year price fluctuations and in some cases to declining price trends, making them a highly unreliable source of foreign exchange. Some experts have proposed formal international commodity agreements aimed at changing market price behavior. While some commodity agreements are already in existence, they have not provided a complete solution, and few additional commodities appear suited to such agreements. Additional borrowing arrangements to compensate for shortfalls in export earnings, similar to the facility established by the International Monetary Fund (IMF) in 1963, have also been suggested. The staffs of the IMF and the World Bank have been studying the problem of volatile export receipts and are expected to report soon on the additional part these two institutions might play in arrangements to increase the stability of foreign exchange inflows to primary producers.

### *Tariff Preferences*

In the long run, dependence of the less developed countries on primary products can be lessened through increased exports of manufactured goods. The advanced countries can assist in this process by removing some of their current restrictions on imports of those manufactured and semimanufactured goods of particular interest to less developed countries. Since further general tariff reductions seem unlikely in the immediate future, the granting of tariff preferences to less developed countries may represent a way of achieving a more rapid reduction of these barriers.

The 1968 United Nations Conference on Trade and Development (UNCTAD) unanimously endorsed the early establishment of a system of generalized nonreciprocal tariff preferences for less developed countries. The United States and other developed nations are now engaged in discussions to determine whether a mutually acceptable system can be devised.

A generalized tariff preference system would help the less developed countries, but it would be only a modest step toward meeting their total foreign exchange needs. The developed countries are likely to insist on excluding certain products from the preference scheme, and trade in other commodities will continue to be restricted by quotas and other nontariff barriers. Furthermore, the initial benefits of the preference scheme would go largely to the minority of less developed countries that have already begun to export manufactured goods.

### *Foreign Aid*

The experience of the 1950's and the 1960's has demonstrated the value of foreign assistance in promoting economic development. Foreign capital and

technical assistance from both public and private sources have been significant factors in the highly successful development efforts of such countries as Greece, Israel, Korea, Mexico, Pakistan, and Taiwan.

While the total volume of foreign assistance has been growing during the 1960's, it has not kept pace with the rising ability of the less developed countries to make efficient use of such funds. Foreign assistance expenditures by the United States rose sharply in fiscal 1962 but have not increased significantly since then. Unless the recent declining trend in appropriations is reversed, expenditures must ultimately fall.

The International Development Association, an affiliate of the World Bank, was established in 1960 to make credits available to developing countries on liberal terms. It has been an effective channel of multilateral assistance, of which the United States has been a major proponent. However, its resources have been largely exhausted and replenishment is essential. It is important that the United States authorize its contribution promptly, because the contributions of other countries depend on the U.S. decision.

## THE BRETTON WOODS SYSTEM

The rapid growth in the world economy in the post war period has been built on a greatly improved financial base. At the 1944 Bretton Woods Conference, the major industrial countries created through the IMF an international monetary system based on pegged exchange rates. The system has been strengthened by the great strides in cooperation in the IMF and in other institutions such as the Organization for Economic Cooperation and Development (OECD) and the Bank for International Settlements (BIS).

This cooperation has paid handsome dividends in times of crisis. International understanding, carefully nurtured during periods of calm, has permitted the multilateral assessment of problems and the determination of mutually acceptable solutions. This was well illustrated in March 1968, when decisions taken with respect to the private gold market ended the immediate threat to stability and basically strengthened the system. At times of severe strain, such as the British devaluation in 1967, international cooperation has contained crises and prevented chain reactions.

To be sure, the international monetary system has had its problems. Crises have occurred all too frequently. Yet the system has consistently been able to meet the needs of the day, it has evolved and adapted, and it can be strengthened further to meet the remaining strains. While conserving proven arrangements, governments seem increasingly ready to consider additional improvements. Proposed evolutionary changes require careful study and deliberation, based on widespread official and public discussions. It is particularly important that these involve the bankers and traders who would be directly affected. The following discussion is intended to contribute to such a dialogue, rather than to make specific recommendations.

International monetary disturbances have centered around three interrelated problems: adjustment, confidence, and liquidity.

“Adjustment” is the process of reestablishing balance-of-payments equilibrium when a country is substantially out of balance. An adjustment problem exists when the relevant forces and policies are either too weak to reestablish equilibrium within a reasonable period or involve domestic or international effects that are inordinately costly.

“Confidence” refers to the willingness to hold monetary assets. A problem arises when holders either become dissatisfied with the safety of some of these assets or see the possibility of profit in switching them abruptly into a different form. This problem is related to adjustment: dissatisfaction with a currency often reflects a lack of faith in the ability of the issuing country to eliminate its balance-of-payments difficulty without resort to a change in its exchange parity.

“Liquidity” relates to international monetary reserves which are held by countries to finance temporary balance-of-payments deficits. If world reserves are too low or too high, or if their rate of growth is inadequate or excessive, a liquidity problem exists. Liquidity needs are closely related to adjustment: the less rapidly and effectively the adjustment process works, the higher the level of reserves needed to finance temporary balance-of-payments deficits, and the less likely it is that any given level of reserves will be adequate.

## THE LIQUIDITY PROBLEM

A country incurs a balance-of-payments deficit when its payments to other countries exceed its receipts from them, apart from “settlement items” required to square accounts. The immediate consequence of a deficit is that the foreign exchange market becomes unbalanced. More of the deficit country’s currency is supplied than demanded at the existing price of the currency, and this will depress the price—the exchange rate. Because of their commitment to a fixed exchange rate, however, central banks intervene to limit the fall in the rate. The floor on the exchange rate is within 1 percent of the official parity established by the country in agreement with the IMF.

In order to prevent the exchange rate from dropping below this floor, a country in deficit must use its foreign exchange reserves to buy the excess supply of its own currency. If the country has ample reserves, it will have sufficient breathing space to restore equilibrium—without resort to policies of excessive domestic restraint or direct intervention in external transactions. If reserves are scanty, however, pressures will develop to deal immediately with the deficit, even through undesirable means. If a general shortage of reserves should occur, economic growth could be retarded by widespread deflationary policies, and international trade and investment could be burdened by restrictions. On the other hand, excessive amounts of reserves could unduly weaken the incentives of deficit countries to adjust, thereby encouraging worldwide inflation.

## TYPES OF RESERVES

Existing stocks of world reserves include gold, foreign exchange, and IMF reserve positions.

Gold is the largest component of reserves, but gold holdings have expanded very little for many years; most recently, they have declined. As was discussed in the Council's 1968 Annual Report, nonmonetary demand for gold seems to be absorbing a substantial and increasing share of current new production at existing prices.

The value of official gold reserves would be increased if the official price of gold were raised. This action is explicitly rejected for compelling reasons. Although it would immediately increase world reserves, it could not provide the orderly growth of reserves needed by the world economy. It would grant unearned windfall gains to private speculators, to gold producers, and to countries holding their reserves mainly in gold; it would encourage speculation; and it would divert scarce resources into the production of a metal already adequately supplied for nonmonetary uses.

The foreign exchange component of reserves grows only if the major reserve currency countries, the United States and the United Kingdom, incur balance-of-payments deficits; and if surplus countries are willing to hold more dollars and sterling. Thus, as the foreign exchange component of world reserves is expanded, the liquidity position of the reserve currency countries may be undermined. It is generally recognized that the United States should not run large deficits, and policies have been formulated and implemented for reaching an acceptable payments position. The United Kingdom also is determined not to run deficits and has in fact designed its economic policy to yield balance-of-payments surpluses in order to retire external debt. To some extent, such debt repayments will actually contract world reserves.

Thus world reserves cannot be expected to grow substantially through expansion of official holdings of either gold or foreign exchange. Some limited expansion through normal IMF lending is to be expected. Reserve positions in the Fund are expanded, however, only when countries draw on the Fund beyond their "gold tranche" or automatic drawing rights. In so doing, they accept obligations to repay. The natural reluctance of countries to become overcommitted to the Fund or to other countries through borrowings sharply limits the probable expansion of reserves in this form.

## SPECIAL DRAWING RIGHTS

In order to deal with the liquidity problem, steps have been taken to create a new international reserve asset, the Special Drawing Right (SDR), as discussed in the Council's 1968 Annual Report. SDR's will be allocated by the IMF to member countries. They will be a form of owned reserves, usable for balance-of-payments needs without an obligation of repayment. Their use is subject only to the reconstitution provision, which requires that dur-

ing the initial 5-year period a country's average holdings of SDR's should be at least 30 percent of its average net cumulative allocation over this period.

A draft outline of the proposed arrangements for issuing SDR's was approved at the 1967 meetings of the IMF in Rio de Janeiro and subsequently translated into legal form by the Executive Directors of the Fund. In March 1968, at a meeting in Stockholm of Ministers and Central Bank Governors of the major industrial countries, a consensus was reached on an amendment to the IMF Articles of Agreement. The amendment was subsequently approved by an overwhelming majority of the Board of Governors of the Fund.

The amendment was then submitted to member countries for ratification, which requires acceptance by 67 member countries (total membership is 111) having 80 percent of the voting power in the IMF. By January 1, 1969, the amendment had been accepted by 27 countries representing 47 percent of the voting power. Seven countries have taken the further required step of depositing with the IMF instruments of participation indicating that they are prepared to carry out their obligations under the proposed amendment. The United States, acting with overwhelming bipartisan support in the Congress, was the first country to complete both of these steps. When participation has been certified by member countries having 75 percent of total IMF quotas, the new facility will be established in the Fund.

Resolving the world liquidity problem requires actual creation of SDR's—a major step beyond legal establishment of the facility. The basic decisions lie ahead—namely when to activate the facility and in what amounts. These decisions will require collective judgment concerning the desired growth of world reserves and the portion of that growth which should take the form of Special Drawing Rights.

#### THE NEED FOR RESERVE GROWTH

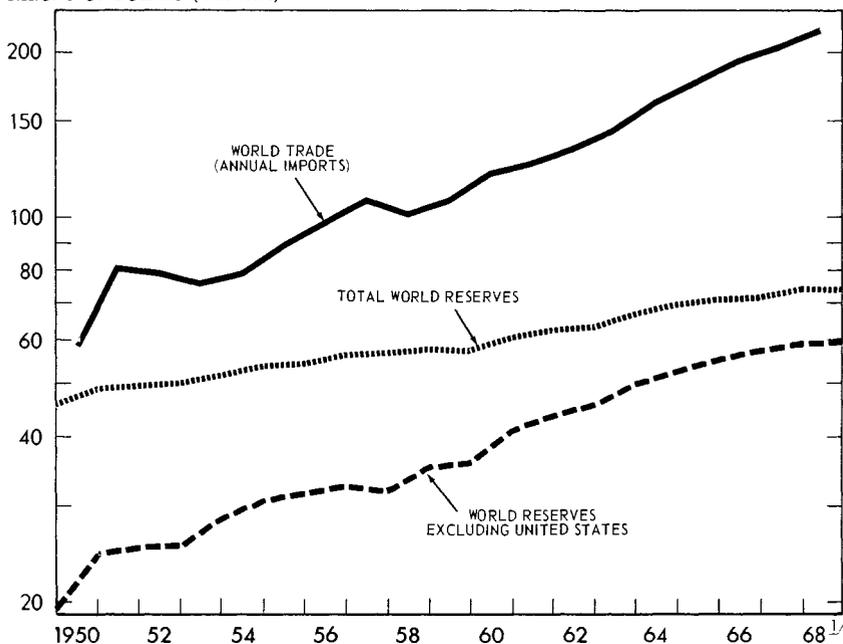
The problem of estimating reserve needs has attracted much interest among economists and government officials in the last few years. The needed volume of reserves depends in part on the probable size of temporary balance-of-payments deficits which must be financed, because this affects the judgment of monetary authorities as to the amounts of reserves they need to hold. According to findings by the staff of the IMF, the magnitude of deficits requiring financing has tended to increase at the same rate as the volume of world transactions. This suggests that the prospective growth of world transactions might be a helpful guide to the required growth in reserves. Since trade in commodities makes up the largest portion of international transactions and is the one most reliably reported in statistics, it is useful as an indicator of trends.

The historical relation between the growth of reserves and the growth of trade (measured by imports) is depicted in Chart 9. Between 1950 and 1968 imports increased 7.6 percent a year, while reserves grew at only 2.5 percent a year. Thus, in the aggregate, reserves declined quite substantially

Chart 9

## World Trade and Reserves

BILLIONS OF DOLLARS (ratio scale)



<sup>1/</sup>ESTIMATES BASED ON DATA FOR FIRST 3 QUARTERS.

NOTE.—TRADE DURING YEAR, RESERVES AT END OF YEAR. DATA INCLUDE YUGOSLAVIA, BUT EXCLUDE U.S.S.R., OTHER EAST EUROPEAN COUNTRIES, MAINLAND CHINA, AND CUBA.

SOURCE: INTERNATIONAL MONETARY FUND.

in relation to imports, and probably in relation to the average size of deficits. These over-all results are, however, heavily influenced by the large net decline in reserves of the United States, the world's largest holder. The United States was able to give up these reserves because of its excess holdings at the beginning of the period. But this loss cannot continue. No other country now appears to have excess reserves sufficient to replace the United States as a willing and able net loser of reserves.

The relationship between growth of reserves and growth of imports is significantly altered when the United States is excluded from world totals. Between 1950 and 1968, reserves of countries other than the United States grew 5.6 percent a year, on the average, while their imports grew at 7.8 percent.

Some have suggested that reserves in the future should grow at essentially the same rate as world transactions—about 8 percent a year—to avoid any further decline in the ratio of average reserves to potential deficits. However, the world economy has been able to adapt to reductions in this ratio in the past. And a moderate further decline may be appropriate, both because countries should have increasing access to borrowed reserves and because

possible improvements in the adjustment process may reduce the need for reserves.

Some guidance might be derived from the 5.6 percent growth rate of reserves experienced between 1950 and 1968 by countries other than the United States. In any case, a major increase from the very slow growth of the past 2 years is needed. Whatever the desired rate of growth of reserves, its achievement will depend mainly on the creation of Special Drawing Rights, since other components of total reserves, as noted above, are unlikely to expand significantly.

While it is still too early to make a decision about the proper size of the initial issue of SDR's, amounts of \$1 billion or \$2 billion a year—which have been used as illustrative examples of SDR creation—appear to be inadequate. These amounts imply a rate of reserve growth of only about 1.4 to 2.8 percent. With such slow growth, the SDR facility might fail to achieve its objective of avoiding a destructive competition for reserves.

### THE CONFIDENCE PROBLEM

Shifts in confidence can be reflected in two ways: through actions initiated in the private economy and through actions by governments. Private holders of liquid assets constantly adjust the composition of their holdings. When they decide to shift from the financial assets of one country to those of another—a process described for simplicity as shifting from one currency to another—either exchange rates or official reserve holdings or both are affected. In addition, shifts by private holders between currencies and gold can have an impact on monetary stability, although the significance of such shifts has been substantially altered by the gold accord reached in Washington in March 1968.

#### PRIVATE SHIFTING AMONG CURRENCIES

Some shifts by private holders out of one currency into another are merely responses to differentials in short term interest rates. Other shifts among currencies may be induced by the expectation of, or anxiety about, a change in exchange rates—and thus can be viewed as reflecting changes in confidence. Such speculative movements occur when the payments and reserve positions of some countries create significant uncertainties that exchange parities will remain fixed. Speculative capital flows can result from direct sales of the suspect currency for stronger ones, or through the operation of the so-called “leads and lags” mechanism, under which normal commercial disbursements denominated in foreign currency are accelerated while receipts denominated in domestic currency are delayed. (This was an important element in the 1968 French crisis.) A crisis of confidence can severely deplete the monetary reserves of a nation. Flows of this kind can be very large—up to \$1 billion in a single day.

Crises resulting from shifts of confidence have occurred from time to

time. At different times in 1968, the Canadian dollar, the British pound, and the French franc were under downward pressures, and the German mark was subjected to upward pressures. As international businesses and financial institutions have matured, additional currencies have been brought into wide international use. Thus the number of currencies potentially subject to such crises has increased.

It is quite appropriate that countries should borrow reserves, if necessary, to deal with temporary emergencies of this kind. The "swap network" has traditionally provided lines of credit among central banks for this purpose; it was expanded and enlarged during 1968. Further improvements could be made in central bank borrowing procedures through a proposal whereby speculative funds would be immediately "recycled"—returned to countries suffering losses from countries experiencing gains.

Even if generous lines of short term credit are available, they leave countries vulnerable, because crises may be long lasting. Lenders or borrowers may be reluctant to renew loans, fearing overcommitment. Fortunately, in recent years, improvements in cooperation among the central banks and in the procedures of the IMF have reduced such fears.

However generous borrowing facilities may be, they cannot deal fully with a crisis of private confidence that arises from a major disequilibrium in the underlying balance-of-payments position of a country. In such circumstances, prompt and decisive measures to achieve a basic adjustment are the key to the restoration of confidence. But the requirements for adequate adjustment are aggravated when a loss of confidence imposes a heavy drain on reserves.

#### PRIVATE DEMAND FOR GOLD

Private asset holders may respond to a loss of confidence in a currency by buying gold rather than other currencies, particularly when the choice of a "safe" foreign currency is not obvious. Gold speculation is rather common in many countries, although not in the United States where it is illegal. Private imports of gold can be an important channel for currency flight and thus become a claim on a country's reserves. Furthermore, because the price of gold in the private market is sometimes used by speculators as a barometer of confidence in currencies, increases in that price can intensify currency runs.

While governments still retain some concern over private demands for gold, they are now much less directly involved than prior to March 1968. For the preceding 7 years, countries participating actively in the "gold pool" had stabilized the price of gold in the private market in London by buying and selling near the official price of \$35 an ounce. In March 1968, these countries agreed to discontinue their activities.

Prior to 1966, the pool was a net purchaser of gold, and the resulting additions of gold to monetary reserves strengthened the international monetary system. Subsequently, however, the pool became a substantial net

seller, parting with gold out of monetary stocks to keep the price from rising. Following British devaluation in late 1967, and in the early months of 1968, the volume of net gold sales became a serious drain on international monetary reserves. Moreover, the market took on a highly speculative tone. Several large and irregular waves of gold purchases had destabilizing domestic monetary effects in certain countries and transmitted speculative fever to foreign exchange markets.

In March, the active gold pool countries agreed to cease selling gold in the private market, and agreed that purchases of gold from the private market were no longer necessary. They obtained the cooperation of other central banks in this decision. As a result, the international monetary system has been substantially insulated from the destabilizing effects of changes in the private demand for gold, and gold can no longer be drained from monetary stocks into private uses.

### SHIFTS AMONG OFFICIAL RESERVE ASSETS

Problems may arise if monetary authorities decide to shift their holdings abruptly among the various reserve assets. They may shift for political or other reasons, but they are often motivated by changes in the relative degrees of confidence attaching to the future values of these assets. For example, if official holders, fearing a sterling devaluation, were to shift into dollars, the United Kingdom would be forced to give up some of its international reserves. Likewise, if official holders of dollars decided to convert them into gold, the United States would lose some of its reserves. Crises of confidence may feed on themselves; for example, a significant decline in U.K. reserves could further weaken the confidence of both official and private holders of sterling.

Shifts out of officially held sterling by sterling area countries became a serious problem following the British devaluation of November 1967. The great majority of the sterling area countries did not devalue along with the British; thus the purchasing power of the reserves of sterling holders was reduced in terms of their own currencies as well as in dollars. This loss led to a movement toward reserve diversification which became particularly pronounced in the spring of 1968.

In recognition that the burden of such reserve diversification should not be borne by the British alone, 12 industrial countries, including the United States, together with the Bank for International Settlements, set up a new \$2 billion loan facility in September 1968. It was designed to provide finance to Britain to replace reserves lost as a result of the decline of sterling balances within the sterling area. The BIS will act as an intermediary and will obtain the required funds by borrowing in international markets, by accepting reserve deposits from central banks of the sterling area, and by calling upon standby lines of credit provided by the cooperating countries. The United Kingdom has given a dollar-value guarantee to the sterling area on

eligible official sterling reserves, and the sterling-area countries in return have undertaken to maintain an agreed proportion of their reserves in sterling. The new facility should go far toward moderating the sterling diversification problem.

Some observers have pointed to the possibility of large-scale conversions of dollars into gold by central banks. The likelihood of such an abrupt shift of preferences must, however, be viewed in perspective. There are several reasons why countries choose to hold dollars. Dollars are useful because they can be readily employed in exchange markets and are more easily put to use in emergencies than gold. Countries recognize that they can convert dollars to gold as they see fit, although they may at times refrain from gold conversions through a cooperative desire not to weaken the international monetary system by reducing total world reserves. Dollars—unlike gold—earn interest, and the efficient American money and capital markets make investment easy. Thus there is and should continue to be a strong demand for dollars by central banks.

Some central banks have a preference—arising mainly from tradition—in favor of gold as a reserve asset. They often appear unconcerned about earning interest on reserves, perhaps because their income is usually turned over to their national treasuries.

When dollars are acquired by countries with a preference for gold from countries with a preference for currencies as reserves, conversions into gold may occur. This could happen even with no increase in total dollars held abroad and no shift in general sentiment toward gold or away from the dollar. Furthermore, as world reserves grow, there would be a demand for added gold if countries attempted to maintain their “traditional” ratios of gold to total reserves. However, countries recognize that gold will decline as a proportion of total world reserves. And as the SDR agreement indicated, they seem prepared collectively to adjust the composition of their reserve holdings.

Preferences that now exist among sterling, dollars, and gold could become more complicated as SDR's are added, thereby creating further possibilities for shifts in the composition of reserves. Certain safeguards, however, were provided in the plan: the power given the IMF to direct SDR's to various holders was designed to prevent inadvertent destabilizing shifts from SDR's into other types of reserves. Furthermore, additional SDR's could be created to offset world reserve losses arising from shifts among reserve assets.

#### PROPOSALS FOR IMPROVING RESERVE MANAGEMENT

It has been suggested that agreement on mutually acceptable rules of reserve management might help to avoid destabilizing changes in reserve composition. If deficit countries used each of their reserve assets in proportion to its share in their total holdings, and if surplus countries were

willing to accept and hold different types of reserves in the exact proportions made available, the system would be internally consistent. Before such rules could be endorsed, their workings would need to be examined and agreed upon in detail.

A more sweeping suggested reform would be to eliminate the differences among reserve assets. Countries could combine all their reserves by depositing them in a joint account, which would be drawn upon when reserves were used. Such a scheme was discussed in the September 1968 Report of the Subcommittee on International Exchange and Payments, of the Joint Economic Committee (JEC) of the Congress. In an examination of proposals of this kind, many questions arise which would require careful study: What would be the role of the United States? Would participation be voluntary or compulsory? Would countries be permitted to withdraw from the pool? In view of the progress already made in dealing with world liquidity and in strengthening international cooperation, how urgent is such a major reform?

### THE ADJUSTMENT PROBLEM

The Bretton Woods system was designed to correct the weaknesses in the international monetary system that were apparent in the interwar years. Faced with domestic economic collapse during the 1930's, some countries attempted, by deliberately undervaluing their currencies, to stimulate exports, retard imports, and thus add to employment. But one country's gain was another country's loss. Competitive devaluations, and restrictions on exchange and trade, imposed a heavy toll on international commerce.

The postwar economy was built upon the general understanding that full employment would be the target of national economic policies, and that this goal would be sought primarily through domestic monetary and fiscal policies. It was also expected that excessive price increases would normally be avoided. In the absence of both chronic deflation and chronic inflation, continuous balance-of-payments problems were viewed as unlikely. The IMF was to help in the adjustment process by granting credit to allow countries time to adjust without parity changes.

Provisions were included to put pressure on surplus countries to take an appropriate part in the adjustment process—for example, the “scarce currency” clause, which permits discrimination in trade against persistent surplus countries whose currencies are formally declared to be scarce. Under these conditions, a system of stable exchange rates was expected to operate successfully and to stimulate international trade and capital movements, while removing the temptation for governments to solve domestic problems by external means.

Although pegged parities were made the normal operating rule of the system, provision was also made for changing parities to correct fundamental disequilibria. The meaning of “fundamental disequilibrium” was not fully clarified, but the expectation at the time was that changes in parities would not be unusual. Actually, parity changes for developed countries have been

rare. In part, this is because major countries have been reasonably successful in avoiding excesses of inflation and deflation; but it also reflects concern about the serious economic and political consequences of changes in the parities of major currencies, including the possibility of a worldwide chain reaction. Furthermore, greater freedom for international capital transactions has complicated the process of changing parities.

#### CAUSES OF DISTURBANCES

Despite the real accomplishments of stabilization policies, the international economy has been subject to disturbances. Some have been caused by the relatively mild cyclical fluctuations that have occurred, and others by differences among countries in long term trends of prices, economic growth, technological advance, and import demand. Countries differ with respect to the maximum rate of price increase—or the maximum volume of idle resources—that they view as tolerable. In general, a country incurring price increases greater than the average of other countries will find its exports becoming less competitive and its domestic market more accessible to imports. Countries which grow particularly rapidly tend to experience stronger increases in imports (although they may simultaneously improve the competitive position of their exports). Or a country may experience long term deterioration in its external position if its demand for imports is more responsive to income growth than is the demand for its exports. These factors, singly and in combination, have led to some serious imbalances.

Adjustment problems may also reflect, in part, an insufficient growth of global reserves. When over-all reserves are growing only slowly, there can be acute pressures on deficit countries to adjust. At the same time, surplus countries may find that their reserves are not accumulating too rapidly; hence they may have little incentive to correct their imbalances. A world shortage of reserves could particularly complicate the adjustment problem of the United States, subjecting it to intense pressures from other countries in weak payments positions or from countries not satisfied with their reserve holdings. The United States might literally be prevented from correcting its balance-of-payments deficit, because every improvement in the U.S. position would cause some other countries to take protective actions to counter any weakening of their own positions.

There are a number of means open to a country for correcting balance-of-payments disequilibria without altering its exchange rate. These means differ in speed, in effectiveness, and in their side effects. They include internal measures such as fiscal and monetary policies, together with supporting incomes, manpower, and regional policies; and direct measures affecting international movements of goods, services, or capital.

#### INTERNAL ADJUSTMENTS

Often the domestic policies which would contribute to balance-of-payments adjustments are also desirable for domestic reasons. Thus if a country

faces a balance-of-payments deficit and rapidly rising prices, it should follow tighter monetary and fiscal measures, supported by incomes policy to help restrain wages and prices, both to improve its trade balance and to curb inflation. Indeed, one argument sometimes made in favor of a system of fixed exchange rates is that balance-of-payments deficits stiffen the resolve of governments to achieve price stability. Conversely, if high levels of unemployment are accompanied by payments surpluses, expansionary domestic policies are clearly indicated.

However, a country may face a balance-of-payments deficit at a time when domestic demand is not excessive. It will then be understandably reluctant to attack its payments problem by restrictive monetary and fiscal policies. The opposite problem may arise if a payments surplus occurs when the domestic situation calls for anti-inflationary policies.

While the situations of surplus and deficit countries are symmetrical, incentives to adjust may not be equally strong in the two cases. There is no definite limit on the accumulation of reserves, so surplus countries often are under little pressure to restore equilibrium. But for deficit countries whose freedom of action is constrained by a limited supply of reserves, pressures to take corrective action may become inexorable. If real progress is to be made in achieving a better balance of world payments, it is crucial that surplus countries participate in the adjustment process, as was indicated in the 1966 Report on the Balance of Payments Adjustment Process by Working Party No. 3 of OECD.

### *Changes in the Policy Mix*

There are some opportunities to mitigate conflicts between international and domestic goals by altering the mix of monetary and fiscal policies. By influencing interest rates, monetary policies have direct effects on capital flows as well as on domestic demand. If a country has a balance-of-payments deficit and a satisfactory or inadequate level of domestic demand, fiscal policy may be eased and monetary policy simultaneously tightened. This combination can, in principle, avoid any reduction of internal demand, and capture the benefits of tighter money in reducing capital outflows or attracting foreign capital. Thus it may be possible to improve the balance of payments without adding to unemployment. The reverse combination of policies may be used by countries facing the surplus-inflation dilemma.

While changes in the mix of monetary and fiscal policy have significant possibilities, and they can be reinforced by appropriate incomes and manpower policies, such adjustments cannot always be relied upon as an escape from major conflicts in objectives.

Some of the balance-of-payments gains resulting from interest rate adjustments may be temporary. A change in interest rates may initially cause investors to make large adjustments in the composition of their existing portfolios of financial assets. Once this initial stock adjustment is completed, however, further gains from this source may be quite small.

There are limits on the willingness of countries to alter the mix of monetary and fiscal policies. A deficit country may hesitate to raise interest rates, fearing that such a move would deter capital formation and thereby curtail the improvement in productivity that may be a basic solution to its balance-of-payments difficulties. Or high interest rates may be objectionable because of their uneven impact on the domestic economy. Or a growing level of foreign indebtedness may be undesirable because it will increase the burden of service payments.

Finally, increases in domestic interest rates may lead to higher interest rates abroad. In that event, the differentials between foreign and domestic rates may diminish, weakening the impact on capital flows. In the absence of international coordination of monetary policies, efforts by deficit countries to tighten credit may lead to a worldwide escalation of interest rates. This may not only impede the immediate objectives of the deficit countries but may also dampen world economic growth. Clearly, the adjustment mechanism could benefit from a continued strengthening of international cooperation in this area of policy.

Thus there are often important limitations on the practical scope for adjustments in the monetary-fiscal mix as a means of reconciling domestic and international objectives. One important principle stands out. In a country with a serious balance-of-payments problem, the use of monetary policy for expansionary domestic purposes may be severely constrained; and primary reliance may therefore have to be placed on fiscal policy to pursue stabilization objectives. In the United States and in many other countries, this implies the need for greater speed and flexibility in the implementation of fiscal measures.

#### MEASURES DIRECTLY AFFECTING INTERNATIONAL TRANSACTIONS

In the OECD Adjustment Process report, it was recognized that fiscal and monetary policies, no matter how skillfully combined, cannot always be relied upon as the exclusive means of balance-of-payments adjustment. Given the many goals of economic policy, numerous instruments are needed. Under some circumstances, the report suggests the use of measures directly affecting international transactions.

Most countries do make use of specific measures affecting trade or capital movements as part of their adjustment. These policies may help to reconcile domestic and international objectives. Such measures as import duties or quotas, export subsidies, changes in border taxes, and taxes and prohibitions on international capital movements offer opportunities for improving the payments balance while avoiding major effects on the domestic economy. Some of these measures, such as special tariffs and export subsidies, are prohibited by the GATT, but their use has at times been sanctioned, implicitly or explicitly, so long as they were considered temporary. Likewise, exchange controls on current transactions are generally discouraged for

countries accepting the full obligations of convertibility in the IMF, but specific authorizations have been granted under emergency conditions.

### *Trade Measures*

The only trade measure explicitly condoned by the GATT for safeguarding the balance of payments is the use of temporary quantitative restrictions. Quotas on imports can be a very powerful instrument. But they can be very disruptive of normal commercial arrangements, troublesome to impose and administer, and difficult to abandon. Over the last few years, developed countries have shown a growing preference for the use of import surcharges, export subsidies, or combinations of the two.

At times, countries change their normal pattern of tax adjustments at the border in an attempt to promote balance-of-payments equilibrium. When a deficit country is taking only partial advantage of its opportunity under the GATT to make border adjustments for domestic indirect taxes, it can help itself by moving to full compensation. However, such action by a surplus country conflicts with the policies that should be followed for balance-of-payments adjustment. For example, on January 1 and July 1, 1968, in conjunction with an internal tax reform, the German government raised its rate of border adjustment. This tended to increase the German merchandise surplus—much as a small devaluation of the mark would have done—and at a time when Germany's balance-of-payments position was very strong indeed.

Another example of a change in a domestic tax which permitted an increase in border adjustments was the action taken by the French government in November 1968. A rise in value-added taxes, which are eligible under the GATT for border adjustments, was substituted for the existing payroll tax, which was not eligible. In this case, the aim of the increase in border adjustments was to help restore over-all payments equilibrium.

Also in November, the German government reduced by 4 percentage points its border charge on most imports and its tax rebate on most exports, without any corresponding domestic tax changes. This measure was taken deliberately to reduce the large German trade surplus and had effects somewhat similar to an upward valuation of the mark.

When countries resort to trade measures to affect their balance-of-payments positions, efforts should be made to minimize distortions. General import charges imposed by themselves favor production for the domestic market, thus shrinking the volume of international trade, while general export grants alone unduly favor production for export. When general import charges are combined with general export grants at the same rate, these two tendencies offset each other, with no more distortion of merchandise trade than would result from a devaluation.

Even such a uniform and general combination of import charges and export grants would distort the choice between merchandise transactions and other international flows, such as tourism. Furthermore, serious misalloca-

tions could occur if exemptions were given individual industries or classes of products. Finally, even under the best of circumstances, temporary trade measures may in practice become embedded and thus should be used with great caution. Nevertheless, this approach may be useful under some conditions. It should be explored further to determine whether proper safeguards can be established to ensure that equal use is made by surplus and deficit countries, and that the goals of liberal commercial policy are maintained.

### *Capital Account Measures*

All major countries take actions at times to influence international capital flows. The techniques employed range from special incentives for domestic investment to exchange controls and capital issues committees. There is some rationale for concentrating on the capital account, since fewer basic adjustments in the allocation of real resources are required by shifts in financial flows than by changes in trade. And measures to influence the capital account are generally more easily reversed in response to shifting balance-of-payments fortunes.

Sometimes, however, restraints on capital movements develop into a patchwork of controls that involve major administrative difficulties, bear down unevenly and inefficiently on different types of capital flows, and create a search for loopholes. The distortions can be reduced to the extent that restraints can be applied more equally among categories of capital flows and interference can be minimized within any particular category.

There may be opportunities to make greater use of the price system by applying variable taxes to capital flows or by auctioning permits to export capital. While the allocation of capital might be improved and administrative burdens eased by innovations in the techniques of controlling capital flows, any system of major restraints is bound to be far from ideal. The possible need for temporary direct measures on the capital account must be recognized, but so should the long term benefits of greater freedom in capital flows among nations.

## THE ADJUSTMENT PROBLEM OF THE UNITED STATES

The difficulties of balance-of-payments adjustment for deficit countries are evident from the recent experience of the United States. In the early 1960's, the United States was faced with a payments deficit at a time when its economy was operating far below capacity.

The causes of the deficit were numerous. The United States was shouldering an extraordinarily large share of the burden of providing for the security of the Free World and of supplying aid to less developed countries. The United States possessed the only large and sophisticated capital market in which foreigners could borrow freely, and the European countries had advanced to the point where they desired capital and could attract it. Moreover, because of Europe's general economic progress and the formation of the EEC and the European Free Trade Association, American companies

had developed an intense interest in making direct investments there. Finally, the U.S. competitive position had deteriorated during the 1950's.

### *The Over-All Strategy*

In the early 1960's, U.S. domestic needs called for expansionary policies, while traditional balance-of-payments remedies would have required greater restraint on demand. To reconcile this conflict, a mixed strategy was followed. It emphasized those elements in the domestic expansion which tended to improve international competitiveness, together with specific measures of a temporary nature to influence the external position. The selection of balance-of-payments measures reflected several concerns: the determination to maintain, as far as possible, liberal policies with respect to international trade and capital flows; the desire not to shift problems to countries in a weak balance-of-payments position; and the need to maintain the stability of the international monetary system, which was so crucially dependent on the dollar. Further difficulties in designing appropriate balance-of-payments measures arose from uncertainty over how much correction was needed, from the unpredictability of the immediate quantitative impact of particular actions, and from the large and uncertain "feedback" effects inherent in the large size of the United States.

Some policies were clearly desirable on all counts, such as improving knowledge with respect to export prospects, trimming unnecessary government expenditures abroad, encouraging other industrial countries to give larger amounts of aid to less developed countries, pressing for a more equitable sharing of military burdens, and removing a tax penalty on foreigners trading in American securities.

### *Reducing the Impact of Government Activities*

A further group of measures to reduce the foreign exchange costs of U.S. military and foreign aid required more difficult decisions. In principle, savings of foreign exchange in the military area could have been pursued through three alternative strategies: (1) reducing the level of security, (2) obtaining increased contributions of military forces from other countries, or (3) reducing, offsetting, or neutralizing the foreign exchange costs of a maintained level of U.S. military effort. The first alternative was ruled out. The second was pursued but with little immediate prospect of success. Thus the third became the approach emphasized in the short run. Domestic producers were given a preference over foreigners in supplying defense needs, at some added cost to the Federal budget. Foreign governments were urged to purchase more of their military equipment in the United States. In recent years, special U.S. Treasury bonds have been sold to countries to neutralize their balance-of-payments inflows from U.S. military expenditures.

Reducing the foreign exchange costs of U.S. aid presented an equally difficult choice. Either the amount of foreign aid had to be reduced, or a

method had to be found to ensure that more of the money provided by the United States was spent in this country. The second alternative—aid-tying—was chosen. This tended to reduce the effectiveness of a given dollar amount of aid, but the alternative of slashing the volume of aid would have been even more costly to recipient countries.

### *Restraining Capital Outflows*

While gains were obtained through these measures in the early sixties, the over-all payments problem was intensified by a major increase in private capital outflows. Faced with an apparently insatiable demand for capital abroad, the United States had the choice of raising domestic interest rates enough to price foreigners out of our market, of taxing foreign loans specifically, or of using direct controls to stop capital outflows. The first alternative was inconsistent with domestic needs for economic expansion. The second alternative was chosen when the Interest Equalization Tax (IET) was proposed in 1963. It substantially reduced foreign portfolio investments by Americans, except new security issues from Canada and investments in less developed countries, which were exempted. But demand for capital shifted to American banks, so the IET was extended to longer term loans of banks. Other types of bank loans and direct investment were not covered by the tax, and these forms of capital outflow kept expanding.

In response to a large outflow of capital at the end of 1964, voluntary programs were initiated in February 1965 to cover the major remaining capital flows. The American corporations which were large direct investors were asked to help by reducing their capital expenditures abroad, by relying on foreign financing for a greater share of their investments, or by expanding reflows of dividends to the United States. Banks and other financial institutions were meanwhile asked to follow guidelines established by the Federal Reserve Board which suggested quantitative limits on foreign lending.

Most, if not all, of these measures have been successful in achieving the objectives for which they were designed. The basic balance-of-payments position improved through 1964 and 1965, and the liquidity deficit was sharply reduced. Further progress was interrupted in 1966 by the mounting foreign exchange costs associated with the war in Vietnam and by the reduced trade surplus resulting from overly rapid domestic expansion.

Because the U.S. external position deteriorated sharply late in 1967 and the stability of the international monetary system seemed in serious danger, a new set of measures was proposed by the President on January 1, 1968. This program included mandatory restrictions on foreign direct investment, further tightening of the guidelines on lending by banks and other financial institutions, and various other steps to reduce the deficit. The program was successful. As noted in Chapter 1, the balance of payments has improved. In particular, American direct investors have managed to finance a

much greater proportion of their investments abroad by foreign borrowing, and there has been a net reduction in U.S. bank credit to the rest of the world.

With the exception of more timely action to assure adequate domestic restraint in recent years, it is hard to see, even in retrospect, any preferable strategies in U.S. policies to correct the deficit. The eclectic, ad hoc measures that were taken involved certain costs. But they maintained the strength of the dollar and the health of the world economy. More basic improvements lie ahead—pending peace and the restoration of price stability.

## EXCHANGE RATE ADJUSTMENTS

An efficient international adjustment mechanism should permit countries to choose their own domestic economic targets for growth, employment, and price-cost performance. Policies that restore balance at home should not lead to pressures on the international accounts—in the form of either excessive accumulation or rapid depletion of reserves.

Suggestions have been put forward for amending the adjustment mechanism to lessen the conflict between domestic and balance-of-payments objectives. It is claimed by some that greater reliance on changes in exchange rates would work in this direction.

### PRESENT SYSTEM

Present IMF rules provide for adjustments of exchange parities as a means of correcting a fundamental disequilibrium. In practice, however, the process of exchange rate adjustment may involve major difficulties; and in consequence, there is often extreme reluctance to change exchange rates even when balance-of-payments difficulties are severe.

To illustrate, the currency of a country with a large and persistent deficit will become widely recognized as a candidate for devaluation and this may touch off a crisis in private confidence, as discussed above. Speculation based on the prospect of devaluation will aggravate the initial balance-of-payments difficulties and increase the outflow of reserves. To discourage such speculation, governments tend to make categorical assertions that devaluation is not being considered; once such assertions have been made, it becomes a matter of national pride and political reputation to maintain the parity.

Furthermore, an actual adjustment in an exchange rate may generate the expectation of a further change; once an exchange parity has been adjusted, a second adjustment seems less unthinkable. Fear of such a perverse reaction may cause a country to depreciate by an excessive amount in the first instance. This may lead other countries to devalue also, thus reducing the potential balance-of-payments gain of the initiating country. Such a chain reaction can severely disrupt foreign exchange markets. Thus the difficulties

associated with parity adjustments have at times driven countries to commit themselves to existing parities in all but the most extreme situations.

## PROPOSALS FOR EXCHANGE RATE FLEXIBILITY

A number of suggestions—ranging from minor adjustments to far-reaching changes—have been made for altering the current exchange rate arrangements of the IMF.

The most sweeping change, advocated primarily by some academic economists, would be to abandon the pegged exchange system in favor of “floating rates,” completely free to fluctuate in response to market forces.

In contrast, other proposals call for a modest widening of the existing 1 percent limit on fluctuations of rates on either side of parity. Still another type of proposal would provide for small but frequent changes in parities.

Each of the proposals is intended to make adjustments in exchange rates a more acceptable and effective means of correcting payments imbalances, and to reduce the speculative disturbances that sometimes develop under the present system. Opinions differ widely over the probable effects of the various proposals; intensive study would be required before serious consideration could be given to the adoption of any of them. The dramatic advances in world trade and prosperity achieved under the present system provide a strong case for conservatism in considering innovations; at the same time, the recurrence of financial strains has aroused widespread interest in possible amendments to the system.

In general, the wider the latitude for changes in exchange rates, the greater would be the amount of adjustment provided; but also the greater would be the uncertainty of those engaged in international commerce and the possibility of a disturbance to trade and investment relationships.

### *Floating Rates*

While a system of floating exchange rates would ensure essentially automatic adjustment to balance-of-payments disturbances, serious questions arise about its operation.

Advocates of flexible exchange rates are divided on whether official intervention in exchange markets should be permitted. A complete ban on official intervention would be a very radical change, obviating any need for central banks to hold international reserves. Exchange rates might fluctuate quite widely, causing substantial uncertainty. If, on the other hand, official intervention were permitted under a system of floating rates, it might smooth out transitory fluctuations in exchange rates, but it would open up the danger of exchange rate manipulation. For example, a government might wish to drive down the price of its currency in order to strengthen the competitive position of its exports. It is difficult to devise rules which would permit desirable smoothing and yet ban manipulation.

In general, fluctuating exchange rates would require shifts of resources among industries that export, those that compete with imports, and others, as relative prices in world markets reflected changes in exchange rates. Moreover, uncertainty about future exchange rates would concern international traders and investors. They could obtain some insurance by entering forward exchange markets, buying or selling foreign currencies at definite prices for delivery at some specified future date. But such forward transactions might be quite expensive and thus add to the costs of world trade. Furthermore, international investors might not be able to satisfy their needs for protection in forward exchange markets, given the long time horizon of many capital transactions.

Advocates of floating exchange rates believe that the benefits outweigh the costs of these uncertainties. They point out that uncertainty about exchange rates is not unique to a system of floating rates. Indeed, no feasible international system can guarantee against exchange rate adjustments. Moreover, they emphasize that international businessmen live with many uncertainties, both political and commercial. Finally, it is their contention—not universally accepted—that, under floating rates, there would be an easing of pressures for exchange controls and trade barriers.

The adoption of floating exchange rates would constitute a drastic change in the international monetary system. If the present system were functioning very badly and if no other possibility of reform were available, there might be a compelling argument for adopting this one; but such is not the case.

### *Wider Bands*

Under present arrangements, day-to-day market pressures can be reflected in small fluctuations of each exchange rate within a narrow band. Central banks of countries other than the United States intervene in the market by buying and selling foreign exchange to keep the dollar prices of their currencies within 1 percent or less of established parities. The United States rounds out the system by selling and buying gold in dealings with central banks at \$35 an ounce. Proposals have been made by the JEC Subcommittee on International Payments and by others to introduce greater flexibility of rates by widening the permissible band of fluctuation around the par value. With a band of 2 percent on either side of parity, the exchange rate between two nondollar currencies could change by as much as 8 percent. Suggestions for a wider band, like other proposals for greater flexibility in exchange rates, are *not* directed at the official price of gold. The latter is not an exchange rate. There is no need whatsoever for it to be altered to accommodate greater flexibility of exchange rates.

A widening of exchange rate bands could contribute to the adjustment process. The currency of a country with an incipient deficit would fall in price, thus making imports more expensive and lowering the cost of exports

to buyers in world markets. Imports would be discouraged and exports stimulated, strengthening the balance of payments. If the exchange rate approached the floor with its future course expected to be upward, the stimulus might be particularly strong; there would be an incentive to take advantage of the temporary low price of the country's exports.

Advocates of a wider band believe that it might deter speculative runs in two ways. First, the additional adjustment permitted by the wider band might make discrete changes in parities appear less likely, thus reducing uncertainty. Second, a wider band would increase the potential loss on a "wrong bet" against a currency. Under the present narrow band, the speculator has relatively little to lose if he bets against a currency and it is not in fact devalued. With a wider band, the risk of loss would be increased, because a currency that was initially under pressure could experience a larger rebound in price. There is, however, no concrete basis for estimating the extent to which these features would deter speculation.

The wider the band is made, the greater the potential uncertainty about the course of exchange rates, but also the greater the amount of balance-of-payments adjustment which may take place within the band. In an evaluation of a wider band, these conflicting considerations would have to be weighed in determining its optimum width. A very wide band comes close to a floating exchange rate and thus shares the shortcomings of this drastic reform. A small widening of the band, on the other hand, might not markedly reduce the need for, and the expectation of, discrete changes in parity.

### *Gradual Adjustment of Parities*

The evolution toward greater exchange rate flexibility could involve a gradual, limited adjustment of exchange parties. Two forms of the so-called "crawling peg" have been proposed, one discretionary and one automatic.

Under the discretionary variant, a country in disequilibrium would no longer make one substantial change in its parity, but rather would announce a rate of increase (or decrease) in its parity of some specified small percentage per month, until further notice. Once the desired effect had been attained, the country would halt the process. This might make the transition to an equilibrium parity easier, and perhaps curb speculation. Its effect on the political obstacles to changes in parities is not entirely clear; governments might find it just as painful to announce a parity change in a series of small steps as in a single abrupt one. The discretionary crawling peg might therefore be used no more frequently than the present "adjustable peg."

The automatic form of gradual adjustment would remove parities from the direct control of individual countries. Under one variant, the parity on any business day would be the average of the actual exchange rates over the preceding 12 months (or some other suitable period). The actual exchange rate would be within a band around the parity prevailing on that

day, with official intervention permitted only at the floor or ceiling. For a period of 1 year and a band of 1 percent, the largest possible change in the parity—attained only if a currency were continuously at its floor or ceiling—would be 2 percent a year. Larger or smaller potential changes could be permitted by adopting a different period for calculating the moving average, or by altering the width of the band. Again an optimum choice would depend upon the importance of certainty about future exchange rates, on the one hand, and on the speed of balance-of-payments adjustment to be permitted through the crawling peg, on the other.

Unlike fully flexible rates, the crawling peg would not be intended to offset all cyclical and random fluctuations in international transactions; but, unlike a widening of the band, it would permit sizable changes in exchange rates over the long run. Thus it could cope with the problem of modest trends in the equilibrium values of currencies resulting from divergent national trends of prices, economic growth, export supply, import demand, or investment flows.

It might seem that, if a currency showed fundamental weakness and was therefore expected to move downward for an extended period, speculation would become a problem because of the predictability of the exchange rate movement. This kind of speculation could, in principle, be avoided by raising interest rates above the otherwise prevailing level by an amount equal to the anticipated rate of downward crawl of the currency. The exchange gain from moving out of the currency would then be offset by the loss of interest. Such changes in interest rates might, however, necessitate offsetting adjustments in fiscal policy and, as discussed earlier, marked changes in the policy mix are sometimes difficult to achieve. Limits on tolerable interest rate changes would thus be one constraint on the speed of parity adjustment which could be permitted in such a system.

The various proposed modifications in the exchange rate system raise many difficult technical issues, and clearly a proper evaluation of these proposals must be preceded by a great deal of careful study.

## CONCLUSION

By far the most important attribute of the postwar international economy has been steady and rapid growth. The spectacular nature of recent international monetary disturbances should not obscure the mighty contribution that the international economic system has made to world prosperity. World-wide flows of goods and investments have been the cornerstones on which the prosperity of many nations has rested; at the same time, the growth of national economies has made possible the tremendous increases in world trade and international investment.

Trade is the center of the international economic system, and it cannot prosper in the face of highly restrictive national policies. Only a continuous

chipping away at tariffs and other trade barriers can provide assurance against backsliding. Pressures for protection must be successfully resisted.

The fruits of unprecedented prosperity are still not being fully shared by many nations in Africa, Asia, the Middle East, and Latin America. The future growth of these nations must be built primarily on the skills, intelligence, and labor of their citizens. But the developed countries must facilitate the process by providing technical assistance, capital resources, and access to markets.

The international monetary system established at Bretton Woods and developed through the years has made a major contribution to international economic growth. This system has served the world well, but it has increasingly been subject to serious strains.

To ensure the continuing smooth operation of the monetary system, work must go forward on the problems of liquidity, confidence, and adjustment. Great progress has been made in recent years as exemplified by the agreement creating Special Drawing Rights. This achievement required careful study and long negotiations. Similar extensive efforts will be needed in the future if progress is to be maintained, but the prospects for eventual success are bright.

## Combating Poverty in a Prosperous Economy

*. . . the policy of the United States [is] to eliminate the paradox of poverty in the midst of plenty in this Nation by opening to everyone the opportunity for education and training, the opportunity to work, and the opportunity to live in decency and dignity.*

**F**OR OVER 4 YEARS the United States has had an explicit national commitment to eliminate poverty in our society, a commitment enunciated by the President in the State of the Union Message of 1964 and confirmed by the Congress in the above words later that year in the Economic Opportunity Act.

Americans are increasingly prosperous. Median family income in the United States (in constant 1967 prices) rose from \$6,210 in 1959 to \$7,974 in 1967, a gain of 28 percent in 8 years. Yet many families are still not able to attain minimum living standards. A preliminary estimate indicates that in 1968 about 22 million people lived in households with incomes below the "poverty line." While this is far fewer than in the past—more than 40 million were similarly situated in 1960—too many Americans remain poor.

This chapter examines the recent progress in reducing poverty, the nature of the task that remains, and the strategies available for eliminating poverty.

### THE EXTENT OF POVERTY

A family is "poor" if its income is insufficient to buy enough food, clothing, shelter, and health services to meet minimum requirements. Universally acceptable standards for determining these minimum needs are impossible to formulate since the line between physical necessities and amenities is imprecise.

The social and psychological aspects of poverty further complicate efforts to measure poverty. As average incomes rise, society amends its assessment of basic needs. Individuals who cannot afford more than a small fraction of the items enjoyed by the majority are likely to feel deprived. Consequently, an absolute standard that seems appropriate today will inevitably be rejected tomorrow, just as we now reject poverty definitions appropriate a century ago.

## DEFINITION OF POVERTY

Even a rough measure of progress in reducing poverty requires an explicit definition, although the line drawn is unavoidably arbitrary. In its 1964 Annual Report, the Council used a poverty line of \$3,000 annual family income. Since 1965, the Council has employed the more refined definition of poverty developed by the Social Security Administration (SSA).

The SSA poverty lines reflect the differing consumption requirements of families based on their size and composition, the age of members, and whether their residence is farm or nonfarm. The calculations center around the U.S. Department of Agriculture's Economy Food Plan, which in December 1967 added up to a per capita weekly food outlay of \$4.90. For families of three or more, the SSA measure assumes all other family needs can be obtained for an amount equal to twice the family's food requirement. In 1967, the nonfarm poverty threshold for an average four-person family was \$3,335 as compared to a median income, for families of that size, of \$8,995. Poverty lines for different types of households are shown in Table 14.

The problems of low-income families neither begin nor end at any arbitrary poverty line. A sharp decline in poverty may be a misleading indicator

TABLE 14.—*Poverty and near-poverty income lines, 1967*

Household characteristic <sup>1</sup>	Poverty income line	Near-poverty income line
<b>Nonfarm households:</b>		
1 member.....	\$1, 635	\$1, 985
65 years and over.....	1, 565	1, 890
Under 65 years.....	1, 685	2, 045
2 members.....	2, 115	2, 855
Head 65 years and over.....	1, 970	2, 655
Head under 65 years.....	2, 185	2, 945
3 members.....	2, 600	3, 425
4 members.....	3, 335	4, 345
5 members.....	3, 930	5, 080
6 members.....	4, 410	5, 700
7 members or more.....	5, 430	6, 945
<b>Farm households:</b>		
1 member.....	1, 145	1, 390
65 years and over.....	1, 095	1, 330
Under 65 years.....	1, 195	1, 450
2 members.....	1, 475	1, 990
Head 65 years and over.....	1, 380	1, 870
Head under 65 years.....	1, 535	2, 075
3 members.....	1, 815	2, 400
4 members.....	2, 345	3, 060
5 members.....	2, 755	3, 565
6 members.....	3, 090	3, 995
7 members or more.....	3, 790	4, 850

<sup>1</sup> Households are defined here as the total of families and unrelated individuals.

Note.—Poverty and near-poverty income standards are defined by the Social Security Administration; they take into account family size, composition, and place of residence. Income lines are adjusted to take account of price changes during the year.

Source: Department of Health, Education, and Welfare.

of progress if a large number of families are raised just above the poverty line. Accordingly, the SSA has also developed a “near poor” standard averaging about one-third higher than the poverty line but still less than one-half of median income for many types of families. Near-poor income standards are shown in Table 14.

The SSA poverty definitions have some limitations. Since they are multiples of food costs, the poverty lines change only when food prices change, and these prices do not necessarily parallel the prices of other essentials. Regional differences in living costs are not reflected in the poverty line. The income data take no account of income in kind such as health care, subsidized housing, and foodstuffs (except for food grown on farms). No adjustment is made for either net assets or fluctuating incomes, and yet families with savings or temporary income interruptions have different problems than the chronically poor.

These problems are currently under study in an effort to refine the poverty concept. A different threshold could affect the distribution of measured poverty among various groups but would probably show much the same trend in total poverty over the long run.

## POVERTY TRENDS

With the general rise in family incomes in the postwar period, the incidence of poverty—the percentage of persons in poor households relative to the total population—has declined sharply from 30 to less than 12 percent (see Chart 10). The number of persons in poverty declined about 20 million over the past 20 years, including a drop of 12 million since 1963—an estimated 4 million in 1968 alone.

Along with the reduction in the number of poor households, the “poverty gap”—the difference between the actual incomes of the poor and the incomes necessary to place them above the poverty line—has been reduced. The poverty gap fell from \$13.7 billion in 1959 to \$9.7 billion in 1967, measured in current dollars.

### *Distribution by Community Type*

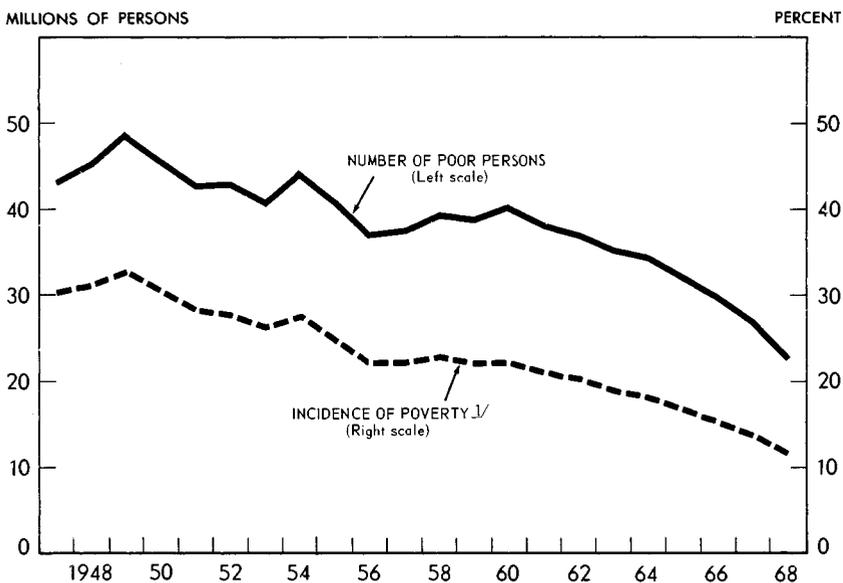
The incidence of poverty is highest—23 percent—in those rural areas not in metropolitan counties, with the heaviest concentrations in the South and Appalachia. The incidence is also quite high—19 percent—in the smaller cities and towns outside of major metropolitan areas. In the central cities, the incidence is 16 percent and in their suburbs about 9 percent.

### *Racial and Ethnic Distribution*

Most of the poor are white. In 1967 (the latest year for which detailed data on the poor are available), 71 percent of all poor families and 83 percent of all poor unrelated individuals were white. The incidence of poverty

Chart 10

## Number of Poor Persons and Incidence of Poverty



$\frac{1}{2}$  POOR PERSONS AS PERCENT OF TOTAL NONINSTITUTIONAL POPULATION.

NOTE.—POVERTY IS DEFINED BY THE SOCIAL SECURITY ADMINISTRATION POVERTY-INCOME STANDARD.

SOURCES: DEPARTMENT OF COMMERCE, DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE, OFFICE OF ECONOMIC OPPORTUNITY, AND COUNCIL OF ECONOMIC ADVISERS.

is far higher among nonwhites: about one household in three compared with about one in seven among whites.

Of the 2.4 million nonwhite households in poverty, 2.3 million are Negroes; the remainder are mostly the original Americans—Indians and Eskimos. A 1964 survey revealed that 74 percent of the 55,000 families living on Indian and Eskimo reservations had incomes under \$3,000.

Only recently has the reduction of poverty among nonwhites matched the reduction among whites. Between 1959 and 1962, the number of whites in poverty declined 2.8 million, but during the same period the number of poor nonwhites rose by 0.9 million. Between 1962 and 1967, white poverty was reduced another 7 million or about 28 percent, while poverty among nonwhites fell by 3.2 million—also about 28 percent.

The relative position of nonwhite families, after deteriorating in the late 1950's, has improved since 1961. (See Appendix Table B-20.) Only since 1966 has nonwhite median family income as a fraction of white median family income surpassed its previous peak of 57 percent in 1952. Unemployment among nonwhite men age 25 to 54 has recently fallen below 1951-53 levels, but unemployment rates for nonwhite women and nonwhite teenage males are much higher than during the early 1950's.

Most poor white families in the United States are not members of identifiable ethnic groups; however, two groups—Mexican-Americans, living largely in southwestern States, and Puerto Ricans, concentrated in New York City—exhibit disproportionately high incidences of poverty. In 1966, unemployment rates among Mexican-Americans in southwestern cities ranged between 8 percent and 13 percent, two to three times the national average. Subemployment—the sum of unemployment, employment producing earnings too low to provide an escape from poverty, and nonparticipation in the labor force by individuals who have given up hope of finding work—ranged from 42 to 47 percent in the Mexican-American sections of southwestern cities. And while Puerto Ricans constitute only about 8 percent of the New York City population, they have been estimated to represent over one-third of the recipients of welfare and about one-third of all occupants of substandard housing.

### STRATEGIES FOR REDUCING POVERTY

A program for reducing poverty has four principal economic dimensions.

First, sustained high employment and economic growth—key objectives of economic policy for a wide variety of reasons—are prime essentials.

Second, education, training, medical assistance, and access to well-paying jobs are needed by many of the poor to escape from chronic unemployment and low-paying dead end jobs.

Third, three-fifths of the heads of poor households cannot easily enter the labor force because of age or disability, or because they are mothers with sole responsibility for the care of young children. Some workers with large families are not likely—even with training and other types of employment assistance—to earn an income sufficient to pull their families out of poverty. Because increased employment opportunities will not eliminate poverty among these groups, some form of income maintenance is required.

Fourth, poverty is concentrated in “pockets”—city “ghettos” and certain rural areas. The numbers of poor in poverty pockets can be reduced by promoting public and private investment in these communities and by providing relocation assistance to those with employment opportunities elsewhere.

In addition to economic policies, social and psychological strategies have an important role to play. These include information about family planning for those who request it, legal assistance, and the encouragement of self-help organizations. Such programs lie outside the purview of this Report.

### PROSPERITY AND THE REDUCTION OF POVERTY

Virtually all the progress in reducing poverty over the past 20 years has occurred during periods of general prosperity. In three periods of sustained economic expansion—1949–53, 1954–56, and 1961 to the present—

the annual decline in the number of individuals in poverty averaged two million or more a year. In contrast, during recessions the number of poor people has increased. The brief recession of 1954 wiped out half of the gains of the preceding 4-year expansion, and several successive years of sluggish economic performance in the late 1950's increased the number of persons in poverty to about the level of 7 years earlier. (See Chart 10.)

#### EFFECTS OF PROSPERITY

Poor families are affected unequally by economic growth and high employment, depending upon their ability to take advantage of expanded employment opportunities. Recent trends in poverty reduction for different groups are shown in Table 15.

##### *Households with Heads of Working Age*

Economic expansion has caused significant reductions in poverty among households headed by a working-age man. Tightening labor markets raise wages for the poor who are employed, and provide better employment opportunities for the unemployed and for those with very low-paying or part-time jobs. Furthermore, when prosperity pushes unemployment rates to low levels among skilled workers, business is more inclined to train poorly qualified workers for skilled jobs. From 1964 to 1966, the number of poor households headed by a working-age man with work experience fell 400,000 a year; in contrast, there had been no decline from 1959 to 1961.

The number of poor households headed by a working-age woman with job experience has not changed during the 1960's. The decline in the incidence of poverty among this group reflected a rise in the total number of households headed by working-age women.

Prosperity is less effective in reducing poverty among households headed by women for several reasons. Women are far less likely to be employed than men; only about three-fifths of the women who head families have some job experience, compared to about 90 percent for male family heads. Many women who head families, being the adult solely responsible for young children, are unable to accept full-time employment unless day care is provided for their children. Furthermore, women are far less likely to escape poverty even if they do work, because their employment is less steady and they earn lower wages. Nonwhite families are more than twice as likely—and white families are more than three times as likely—to be poor if headed by a woman than if headed by a man.

##### *Elderly Households*

During the 1960's, the number of poor elderly households fell slightly, while the incidence of poverty among this group decreased substantially. High employment has some immediate effect on poverty among the aged

TABLE 15.—Number of poor households and incidence of poverty, selected years, 1959–67

Characteristic of head of household	1959	1961	1964	1966 <sup>1</sup>		1967
				Originally published	Revised	
Millions						
<b>Number of poor households:<sup>2</sup></b>						
Total.....	13.4	13.0	11.9	10.9	10.7	10.2
Head 65 years and over.....	3.9	3.9	3.8	3.9	4.0	3.8
Unrelated individuals.....	2.5	2.5	2.8	2.7	2.7	2.7
Families <sup>3</sup> .....	1.4	1.3	1.1	1.2	1.2	1.1
Head under 65 years.....	9.4	9.1	8.0	7.0	6.8	6.4
Unrelated individuals.....	2.6	2.4	2.3	2.1	2.1	2.2
White.....	1.9	1.8	1.8	1.6	1.6	1.6
Male.....	.6	.6	.6	.5	.6	.5
Female.....	1.3	1.2	1.2	1.1	1.0	1.1
Nonwhite.....	.7	.7	.5	.5	.5	.5
Male.....	.3	.3	.2	.2	.2	.2
Female.....	.4	.4	.3	.3	.3	.3
Families <sup>4</sup> .....	6.8	6.7	5.7	4.9	4.7	4.2
White.....	4.9	4.7	4.0	3.3	3.1	2.8
Male.....	3.8	3.7	3.0	2.3	2.2	2.0
Female.....	1.1	1.0	1.0	1.0	.9	.8
Nonwhite.....	1.9	2.0	1.7	1.6	1.5	1.4
Male.....	1.3	1.3	1.1	.9	.9	.7
Female.....	.6	.7	.6	.7	.7	.7
Percent						
<b>Incidence of poverty:<sup>5</sup></b>						
Total households <sup>2</sup> .....	24.0	22.6	19.9	17.8	17.5	16.2
Head 65 years and over.....	48.6	43.8	40.0	38.5	38.9	36.3
Unrelated individuals.....	68.1	64.4	59.9	55.3	56.3	53.4
Families <sup>3</sup> .....	32.5	27.2	21.6	23.0	23.1	20.3
Head under 65 years.....	19.8	18.8	16.0	13.7	13.3	12.2
Unrelated individuals.....	36.8	33.9	31.0	28.3	28.7	27.0
White.....	32.9	29.7	28.3	25.8	25.5	24.4
Male.....	24.6	22.8	22.0	20.1	21.0	18.0
Female.....	39.1	35.2	33.0	30.0	28.8	29.0
Nonwhite.....	54.8	55.0	45.1	41.7	45.3	40.1
Male.....	47.1	45.5	34.6	29.1	35.5	29.4
Female.....	63.5	66.8	58.1	54.1	55.1	51.7
Families <sup>4</sup> .....	16.8	16.1	13.3	11.2	10.6	9.5
White.....	13.4	12.6	10.4	8.4	7.9	7.1
Male.....	11.4	10.7	8.5	6.5	6.1	5.4
Female.....	35.9	33.9	31.2	29.1	27.9	25.3
Nonwhite.....	48.6	47.8	27.8	34.3	33.4	29.9
Male.....	42.1	40.2	32.3	25.9	25.1	20.9
Female.....	71.3	72.8	62.4	61.2	60.3	54.9

<sup>1</sup> The revised estimates differ slightly from those originally published because of the use of a somewhat different estimating procedure. For an explanation of the two methods, see "Current Population Reports Series P-60, No. 54."

<sup>2</sup> Households are defined here as the total of families and unrelated individuals.

<sup>3</sup> Consists only of two-person families whose head is 65 years or over. All other families included in "head under 65 years."

<sup>4</sup> All families other than two-person families whose head is 65 years or over.

<sup>5</sup> Poor households as percent of total households in the category.

Note.—Poverty is defined by the Social Security Administration poverty-income standard; it takes into account family size, composition, and place of residence. Poverty-income lines are adjusted to take account of price changes during the period.

Detail will not necessarily add to totals because of rounding.

Sources: Department of Commerce and Department of Health, Education, and Welfare.

by providing more jobs for elderly individuals wishing to continue work. This opportunity is particularly important for those with retirement income below the poverty line.

Over the longer run, prosperity permits more workers to accumulate assets and to achieve higher pension rights prior to retirement. At present, an individual earning the minimum wage and working full-time in a job covered by social security is entitled to old-age benefits of approximately \$120 a month upon retirement—only about \$10 a month below the poverty line.

Reflecting both the higher lifetime earnings of the aged and statutory improvements, social security retirement benefits have increased greatly and have been the most important factor in reducing poverty among the elderly. Since 1961, legislation has increased social security retirement benefits 21 percent across the board,—substantially greater than the increase in consumer prices. The minimum benefit increased 37 percent.

### *The Disabled*

The ill and disabled have benefited least from recent prosperity and other efforts to alleviate poverty. Although the *incidence* of poverty among households whose heads are under 65 and not working for health reasons fell from 1959 to 1967, the *number* actually rose. Some disabled can be retrained, and these individuals can obtain jobs more readily when unemployment is low. But many who are ill or disabled cannot take advantage of job opportunities.

### *The Near-Poor*

Table 16 shows the number of households and the number of persons who were in the near-poor category in 1959 and 1967.

The compositions of the poor and the near-poor categories differ considerably. Most striking is the difference in the proportion of nonelderly households headed by a working-age woman. These households account for 46 percent of all nonelderly poor households; among the near-poor, they account for 22 percent. Except for the elderly, most near-poor families are headed by men who are employed, but at low wages.

The number of near-poor showed a considerable decline between 1959 and 1967. Many who rose from poverty were added to the near-poor, but at the same time an even larger number of the former near-poor moved to a higher income level.

## PROSPECTS FOR FURTHER PROGRESS

As indicated above, prosperity has played a key role in reducing poverty and is essential to further progress. But sustained growth and high employment—in the absence of other more direct efforts to help the poor—cannot maintain the recent rate of decline in poverty.

TABLE 16.—Number of near-poor households and incidence of near-poverty by age and sex of head of household, 1959 and 1967

Age and sex of head of household	Number (millions)		Incidence of near-poverty (percent) <sup>1</sup>	
	1959	1967	1959	1967
Near-poor households <sup>2</sup> .....	4.3	3.7	7.7	5.9
Families.....	3.8	2.9	8.3	5.8
Head 65 years and over <sup>3</sup> .....	.7	.8	15.2	14.0
Head under 65 years <sup>4</sup> .....	3.1	2.1	7.6	4.8
Male head.....	3.4	2.4	8.4	5.5
Female head.....	.4	.5	8.2	8.7
Unrelated individuals.....	.5	.8	5.1	6.0
Head 65 years and over.....	.2	.5	6.1	9.1
Head under 65 years.....	.3	.3	4.6	4.0
Male head.....	.2	.3	5.5	5.8
Female head.....	.3	.5	4.9	6.1
Addendum: Near-poor persons.....	15.8	12.0	9.0	6.1

<sup>1</sup> Near-poor households as percent of total number of households in the category; near-poor persons as percent of total persons.

<sup>2</sup> Households are defined here as the total of families and unrelated individuals.

<sup>3</sup> Consists only of two-person families whose head is 65 years or over. All other families included in "head under 65 years."

<sup>4</sup> All families other than two-person families whose head is 65 years or over.

Note.—Near-poverty is defined by the Social Security Administration near-poverty-income standards; it takes into account family size, composition, and place of residence. Near-poverty-income lines are adjusted to take account of price changes during the period.

Detail will not necessarily add to totals because of rounding.

Sources: Department of Commerce and Department of Health, Education, and Welfare.

If the 1961–68 reductions in the number of poor persons could be continued, poverty would be eliminated entirely in about 10 years. If the record of 1968 could be continued, poverty would be eliminated in about 5½ years. Maintenance of these rapid reductions will become increasingly difficult because, as poverty declines, an increasing fraction of the remaining poor are members of households whose economic status is least affected by prosperity. Households headed by women with children, disabled persons, or elderly persons accounted for 6.0 million or 59 percent of all poor households in 1967.

Much of the progress in the 1960's has been due to the lowering of the unemployment rate. As that rate fell, further declines were increasingly effective. The hard-core unemployed, the educationally disadvantaged, and the victims of discrimination are the last to be hired during a return to high employment and the first to be fired during a slowdown. Upgrading the unskilled and uneducated to fill shortages in skilled labor takes time. Consequently, if high employment is maintained, these adjustments will continue to reduce poverty, but their effects will gradually diminish. In the absence of increased direct assistance to the poor or further reductions in unemployment, present annual declines in poverty must be expected to become smaller.

The elimination of poverty will be long in coming if the incomes of the

poor grow only at the same pace as the incomes of other households. If the real income (including transfer payments) of each poor household were to grow at 3 percent a year—approximately the average gain for all households during normal conditions of economic growth—eliminating only half of poverty would take 12 years for poor families and 17 years for unrelated individuals. To shorten substantially the period needed to reduce poverty, the incomes of the poor must grow faster than average income—some redistribution to the poor must be made from the benefits of growth.

## INCOME DISTRIBUTION

Only a relatively small redistribution of the benefits of growth is needed to speed greatly the reduction in poverty. If the approximately 85 percent of households that are not poor and receive about 95 percent of total income are willing to make only a small sacrifice of the estimated 3 percent yearly growth in their real income per capita, the prospects for poverty reduction can be greatly transformed. If the increase in real income for the nonpoor is lowered merely from 3 percent to 2½ percent a year and if that differential of about \$2.8 billion annually is effectively transferred to those in poverty, then family incomes for those now poor can grow about 12 percent annually. This redistribution would eliminate the 1967 “poverty gap” of \$9.7 billion in less than 4 years. Since any program of redistribution would be likely to reach some of the near-poor and might raise some poor families substantially above the poverty line before others are affected, perhaps a better projection of the time required would be 6 to 8 years.

The rapid reductions in poverty during the 1960's paralleled a significant rise in the share of total family income going to the lowest income groups. In part, this shift in distribution has been accomplished by increased employment of poor adults at higher wages.

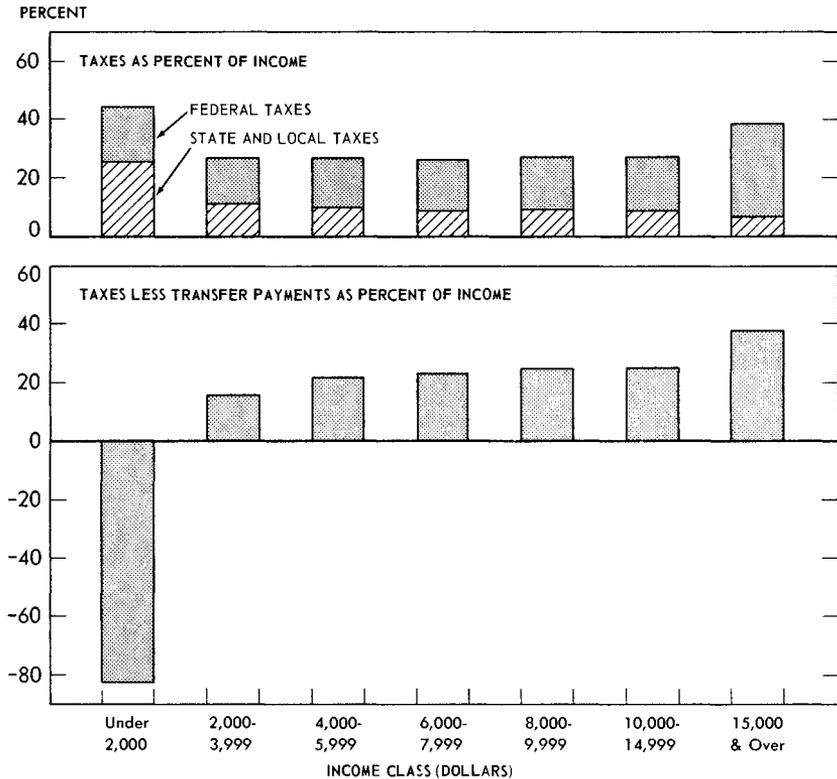
The combined effect of the tax and transfer payment systems at all levels of Government also operates to redistribute income to the poor. The net gain or burden from the public sector for any group depends on the difference between all the benefits received from government expenditures and all the taxes paid. Many programs—like national defense—have benefits that are difficult to allocate by groups; however, the benefits of transfer payments—such as social security benefits, welfare payments, and unemployment compensation—can be allocated and compared with the tax burden. The impact of Federal, State, and local taxes and of transfer payments on the distribution of income in 1965 is shown in Chart 11.

The tax system by itself redistributes income away from the poor. As a share of income, higher taxes are paid by households in the lower income classes than by those with incomes between \$6,000 and \$15,000. This reflects the heavy tax burden on low-income families from State and local taxes—primarily sales, excise, and property taxes. Federal taxes also contribute to this burden through the social security payroll tax.

The poor receive nearly as much from transfer payments as from all other

Chart 11

## Taxes and Transfer Payments as Percent of Income (Excluding Transfers), by Income Class, 1965



SOURCE: COUNCIL OF ECONOMIC ADVISERS, BASED ON DATA FROM A VARIETY OF SOURCES. DESCRIPTION AVAILABLE ON REQUEST.

sources. While these payments do not go exclusively to the poor, they do have a powerful redistributive impact. The ratio of receipts to household income (excluding transfers) is very high in the lowest income classes. As household incomes rise, the proportion of transfers to other income falls sharply.

When government transfer payments and taxes are combined, the concentration of transfer payments in the lower income groups much more than offsets their tax burden. But since average transfer payments fall rapidly as income rises, the excess of taxes over transfer payments as a fraction of income rises much more sharply from \$0 to \$4,000 than in higher income classes.

### EDUCATION, JOBS, AND TRAINING

Education and training measures can improve job opportunities for the poor and their children.

## EDUCATION AND POVERTY

Education can help prevent the children of the poor from remaining poor when they grow up. They are already better schooled than their parents. About three-fourths of poor youths between 16 and 21 either are attending school or are high school graduates, whereas more than half of their parents had no high school education. Yet these youths still have less schooling than their more fortunate contemporaries, 90 percent of whom are in school or are high school graduates.

Although most poor children of all ages are now in school, inferior facilities and poorly qualified teachers lower the value of the education many of them receive. Even schools equivalent to those of the prosperous would not yield equal education. Poverty imposes handicaps that children of more prosperous families do not have.

Children of the poor are less likely to receive good health care and good nutrition, both of which affect success in school. They are also less likely to receive the verbal and intellectual stimulation in their early years that prepares them to master school work. They start school somewhat behind other youngsters, and they receive less parental assistance. Since school does not meet the challenge of helping them catch up, it becomes a place of defeat, leading many to drop out.

Poor children from minority groups suffer another handicap, segregation. More than 60 percent of all Negro pupils in the first grade attend elementary schools in which at least 90 percent of the students are Negro. Not only are facilities and instruction inferior in many of these schools, but studies of educational performance suggests that segregation itself has an adverse effect on school performance.

If poor children are to have equal opportunity to compete successfully for good jobs, they need special help in the preschool years. They also need compensatory education, with expenditures exceeding those made on other pupils. Finally, they need financial help and other encouragement to stay in school and continue their education.

Major efforts have been made to upgrade education provided children of the poor in programs such as the Elementary and Secondary Education Act, the Economic Opportunity Act, and the Vocational Education Amendments of 1968. Head Start, Title I of the Elementary Education Act, and Follow Through are comprehensive programs, combining health care, nutrition, and the involvement of the child's family, as well as education. Most of these special Federal efforts have been in operation for 3 years or less. While too little experience has been gained to allow a full evaluation, enough positive results are evident to justify continuing the programs.

## HIRING STANDARDS

Poverty is perpetuated by hiring standards that arbitrarily discriminate against the disadvantaged.

## *Racial Discrimination*

The persistence of racial discrimination in hiring frustrates the efforts of nonwhites to realize full returns from schooling and discourages the young from remaining in school. For example, a larger portion of white male *dropouts* 16 to 21 years of age secure skilled and semiskilled jobs than nonwhite males who *graduate* from high school, and the average earnings of nonwhite high school *graduates* are lower than those of white *dropouts*.

Attacks are being made on discrimination in higher level occupations, although most of the initial progress is in clerical jobs. The public sector has a better record than the private sector in eliminating discrimination in hiring. For example, 20 percent of the Federal and municipal white collar workers in metropolitan New York City are Negro. In contrast, Negroes hold only 6 percent of the white collar jobs in large private firms in New York City.

## *Restrictive Hiring Practices*

Arbitrary hiring standards and customary employment practices, as well as outright racial discrimination, curtail work opportunities. During World War II, industry successfully adjusted standards and restructured work patterns to fit jobs to the level of workers' skills.

All too often, recruitment and testing procedures currently used by Government and business do not take sufficient account of innate intelligence and aptitude.

## TRAINING AND JOB ACCESS

On-the-job training is an important route to employment. Consequently, the Government increased the number of on-the-job trainees financed under the Manpower Development and Training Act from 11,000 in fiscal 1965 to 125,000 in fiscal 1968. By the end of 1968, half the trainees had less than 4 years of high school, and 53 percent were from families with incomes below the poverty line.

Through the Job Opportunities in the Business Sector (JOBS) program sponsored by the National Alliance of Businessmen, nearly 12,000 cooperating business firms have helped disadvantaged workers find employment. The premise of the program is that the best job training is a job. JOBS encourages waiving of some hiring standards and provides counseling and training to raise the productivity of the trainees. The interim goal of employers pledging to place 100,000 disadvantaged persons by June 1969 has already been met far ahead of schedule. JOBS contracts have been issued to about 800 employers who are reimbursed an average of \$3,000 per trainee for the extra costs.

The rapidly growing public sector has no counterpart to the JOBS program. Such a program would usefully supplement the present expansion of job opportunities in the private sector.

Two other major programs are designed for young workers. The Job Corps helps the most severely disadvantaged youths without job prospects. As of mid-1968, the program had provided health care, food, and job training for 195,000 enrollees since 1965. From 1965 to 1968 the Neighborhood Youth Corps provided jobs for over 1.3 million youngsters from low-income areas. While the part-time and summer work is too low skilled to provide useful job training, the modest pay helps youths from low-income families stay in school.

### IMPROVEMENTS IN INCOME MAINTENANCE

The United States now has a substantial commitment to income maintenance, spending about \$60 billion in fiscal 1968 (Table 17). Each program serves the special needs of a particular group, and many are not designed specifically to help the poor. Individuals who can normally earn an adequate living are served by social insurance systems which protect against loss of income through death, disability, and unemployment, and which provide retirement income. Individuals with inadequate earning

TABLE 17.—Selected major income maintenance programs, fiscal year 1969

Program	Total outlays (millions of dollars)	Beneficiaries <sup>1</sup>	
		Number (thousands)	Percent in households with income less than \$3,300 <sup>2</sup>
All programs <sup>3</sup> .....	58,679	( <sup>4</sup> )	( <sup>4</sup> )
Aid to families with dependent children.....	3,206	6,146	100
Unemployment insurance:			
Federal-State unemployment compensation.....	2,300	5,196	20
Federal employees and ex-servicemen.....	111	489	10
Railroad.....	52	92	( <sup>4</sup> )
Disability programs:			
Workmen's compensation.....	<sup>5</sup> 1,686	( <sup>4</sup> )	( <sup>4</sup> )
Federal employees.....	57	40	15
Veterans' compensation.....	2,611	2,390	24
Railroad.....	77	41	( <sup>4</sup> )
Social security.....	2,691	2,278	39
Aid to the blind.....	92	84	100
Aid to the permanently and totally disabled.....	726	721	100
Assistance to those 65 years and over:			
Social security retirement and survivors' benefits.....	24,681	21,931	31
Old-age assistance.....	1,833	2,123	100
Military retirement.....	2,265	681	( <sup>4</sup> )
Civil service retirement.....	2,364	318	( <sup>4</sup> )
Railroad retirement.....	1,542	969	34
Veterans' pensions.....	2,127	2,252	80
General assistance.....	32	700	100
Assistance-in-kind <sup>6</sup> .....	10,226	( <sup>4</sup> )	( <sup>4</sup> )

<sup>1</sup> Estimated.

<sup>2</sup> Income including cash benefits.

<sup>3</sup> Data exclude State and local government retirement systems and all private retirement and charitable programs.

<sup>4</sup> Not available.

<sup>5</sup> Estimate by Council of Economic Advisers.

<sup>6</sup> Federal outlays only. See Table 18.

Source: Bureau of the Budget (except as noted).

ability may be assisted by welfare, veterans pensions, in-kind payments (such as food stamps or public housing), and manpower training allowances.

Despite recent improvements, existing income maintenance programs provide neither adequate coverage nor sufficient benefits to prevent poverty.

Rarely are able-bodied working-age individuals, or families headed by healthy, nonelderly men, eligible for existing cash benefit programs yet, these groups make up two-thirds of poor nonelderly households. Even among some of the groups for which programs are available, coverage is much less than complete.

Benefits are rarely adequate to raise households above the poverty line. The average Aid to Families with Dependent Children (AFDC) payment in mid-1968 was just over \$2,000 a year per family; in five States, it was less than \$1,000 a year. Average benefits in mid-1968 for a retired couple under old-age insurance were about \$1,800—below the poverty line for such families by about \$200.

## WELFARE PROGRAMS

Important improvements in public assistance have been made. The courts have overturned the controversial “man in the house” rule, which had denied AFDC benefits to children when a man not legally responsible for their care lived with the family. Courts have also declared invalid some State residency requirements for public assistance. States have recently been instructed to determine income need by affidavit, rather than personal investigation, a change to a more efficient and less demeaning method. The work incentive principle was introduced in the 1967 Social Security Amendments, which call for welfare benefits for AFDC mothers to be reduced by less than the full amount of earnings. Finally, the average AFDC benefit rose \$17 per family (11 percent) between mid-1967 and mid-1968.

These improvements have led to the paradox of growing welfare rolls and costs amidst a general reduction in poverty. Not only have welfare applications increased, but between 1960 and 1967, the fraction of applicants declared eligible for benefits rose dramatically. Reform of eligibility rules and increased awareness of welfare programs by the poor have probably been responsible for the substantial rise in applications.

### *The Freeze on AFDC Rolls*

While the welfare system generally has been improved in recent years, the enactment of a sharp limitation on the number of AFDC beneficiaries, now scheduled to take effect July 1, 1969, was a major step backward. The “freeze” forbids Federal financing for any increase in a State’s ratio of deserted or illegitimate children receiving AFDC assistance to the total child population.

In all States, the freeze places a very tight limit on the expansion of welfare rolls; in some it will even cause a decline, unless the States are willing to assume the Federal share of the costs. Eligibility for federally aided

public assistance should not be determined on the basis of the place of a family in the waiting line at the welfare agency, but upon the need of the family. Repeal of the AFDC freeze is the most urgently required step toward a more humane and rational welfare system.

### *Raising and Equalizing Welfare Benefits*

In federally assisted welfare programs—AFDC, old-age assistance, aid to the blind, and aid for the disabled—benefits vary widely among States but are well below the poverty line nearly everywhere. For example, the monthly AFDC benefits for a family of four range among the States from a low of \$40 to a high of \$290 but exceed the poverty threshold in only one State.

Establishing minimum welfare benefits—wholly financed by the Federal Government—could raise the lowest benefits significantly. This minimum could be modest initially and then increased until benefits are adequate in all States. Since poverty is a national problem which happens to be geographically concentrated, federalization of most of the cost of welfare expenditures, perhaps including even administrative costs, would be desirable over the long run. Federal administration would reduce the difficulties arising from major differences in local standards of benefits, eligibility, and administration.

### *Improving Work Incentives in AFDC*

Currently, if a State elects, mothers receiving AFDC may earn up to \$30 a month without having their welfare benefits reduced. Beyond \$30, benefits are reduced by two-thirds of additional earnings. By July 1, 1969, all States must adopt this work incentive formula. While these new provisions are an important advance, work incentives are still too small and do not extend to other welfare categories.

If child-care facilities are available, welfare mothers may be required to work or to accept training in order to receive benefits. At present, shortages of child-care facilities and training assignments limit the impact of this provision. Nevertheless the rule raises fundamental social issues: whether children are better off in a child-care center or at home with their mothers, and whether a mother should be required to work while also performing household tasks for her family.

These issues are not easily resolved. Nevertheless an equitable system should not penalize those who work and should provide adequate benefits to those who cannot work.

## **BENEFITS IN KIND**

Many assistance programs provide goods and services rather than cash. In-kind assistance is often designed to promote those types of consumption

by the poor that also benefit other members of society. For example, society may subsidize housing or health care because eliminating poor housing and ill health benefits the community as a whole. Some in-kind programs, such as school lunches, provide specific goods and services especially important to the young.

In-kind benefits often reflect the standards, tastes, and values of the majority and their desire to influence the consumption patterns of recipients. The well-being of the poor is raised by such programs, but the poor would probably consider themselves better off if they had equivalent amounts in cash and the accompanying freedom of choice.

### Present Programs

Outlays in fiscal 1969 for the major in-kind programs which directly benefit the poor are summarized in Table 18.

*Health.* Medicare and Medicaid account for 84 percent of in-kind expenditures. Medicaid benefits go primarily to the poor, and one-third of Medicare beneficiaries are poor. Because of high maternal and infant mortality rates among the poor, expansion of comprehensive health care for mothers and babies in poor families is especially desirable.

*Food.* The next largest in-kind program is food assistance, which includes food stamps, school lunches, and the distribution of commodities from surplus stocks. Food programs reach a significant number of the poor but as few as 20 percent in some concentrated poverty areas. The coverage

TABLE 18.—Major Federal income-in-kind programs substantially benefiting the poor, fiscal year 1969

Program	Federal outlays (millions of dollars)	Beneficiaries <sup>1</sup>	
		Number (millions)	Percent in households with income less than \$3,300 <sup>2</sup>
Total programs.....	10,226		
Food programs.....	665	11.3	
Food stamps.....	273	3.6	100
Child nutrition.....	128	3.9	100
Special supplementary package.....	9	.2	100
Other direct distribution.....	255	3.6	100
Housing programs.....	484	2.9	
Public housing.....	456	2.8	57
Rent supplements.....	28	.1	67
Health service programs.....	9,077	23.6	
Medicare.....	6,222	9.5	36
Medicaid.....	2,384	9.5	75
Maternity and infant care.....	193	<sup>3</sup> 3.2	70
Public Health Service medical programs:			
Indians, seamen, etc.....	175	.6	55
Neighborhood health centers.....	103	.8	75

<sup>1</sup> Estimated.

<sup>2</sup> Income including cash benefits.

<sup>3</sup> Includes children and mothers benefiting from more than one service of the Children's Bureau.

Source: Bureau of the Budget.

of the food stamp program will expand from 2.8 to 3.6 million persons by the middle of 1969, largely as a result of expansion into new areas and lower stamp charges. The child nutrition program, providing free or low-cost school lunches, is now being expanded.

*Housing.* Two programs to be expanded significantly under the Housing Act of 1968 are directed toward low-income groups—rent supplements and public housing. By midyear, 19,000 families—nearly all poor—will be receiving rent supplements. In fiscal 1969, the number of public housing units available will increase by 75,000, bringing the total to 780,000. Roughly half the occupants are poor.

The average monthly rental in public housing is about \$50, more than many poor families can afford. In the North, the lowest income families in public housing spend more than 30 percent of their income on rent. In contrast, occupants with incomes over \$5,000 pay about one-sixth of their income in rent. Only in the South are the majority of nonelderly public housing tenants below the poverty line.

Public housing could be made more accessible to the very poor in a number of ways. First, higher welfare benefits would help recipients pay present rents. Second, rents could be lowered if the Federal Government subsidized a larger share of public housing costs. Third, rents for the poorest families could be reduced if rents for all tenants were more closely tied to income.

## SOCIAL INSURANCE SYSTEMS

For the vast majority of Americans, social insurance guards against a fall in income due to retirement, disability, survivorship, or unemployment. These programs prevent much of the poverty that in the past resulted from interruptions in wage income. They make remaining poverty problems more manageable.

### *Retirement*

The largest American income maintenance program is social security. About 22 million Americans now receive about \$25 billion in annual benefits from Old Age and Survivors Insurance. The goal of providing every elderly American citizen with a decent retirement income is becoming a reality. Similarly, more and more widows with young children and disabled individuals are being supported above the poverty line.

Rising prices should not be permitted to erode the purchasing power of the retired. Social security benefits should now be increased 10 percent across the board, in line with changes in the cost of living since benefits were last raised and to allow for additional improvement. A revised method of computing benefits, effective in fiscal 1971, would provide another increase.

Many individuals receiving low social security benefits have little if any other income. Increasing the monthly minimum benefit from \$55 to \$80—

and to \$100 for workers with 20 years of coverage—would reduce poverty by more than half a million persons.

The earnings test should be liberalized. At present every dollar earned in excess of \$1,680 a year reduces benefits by 50 cents; earnings over \$2,880 reduce benefits dollar for dollar. Because earnings are subject to other taxes, additional earnings above \$2,880 actually reduce total after-tax income. The tax-free earnings allowance should be raised to \$1,800. Fifty percent of earnings beyond \$1,800 up to \$3,000 and 75 percent of earnings thereafter would be deducted from benefits.

Virtually all workers are now covered either by social security or similar retirement programs. Regular employment will provide retirement benefits above the poverty line for all but the very lowest-paid workers. Most future recipients of low social security benefits will be either individuals covered by other retirement programs or housewives with only a few years of work experience. Neither group will constitute an extensive poverty problem. The most efficient mechanism for assisting the elderly poor is either expansion of Old Age Assistance or establishment of an income-related social security minimum—perhaps financed out of general revenues—far above the standard minimum. Under the latter proposal, social security benefits could be high enough, together with other income, to bring all the elderly above the poverty line.

### *Disability*

The number of poor households headed by the disabled has not declined since 1959. Better Disability Insurance under social security can improve this record.

At present, to qualify for benefits, workers must be disabled 6 months, and the disablement must be expected to last another 6 months or to result in death. To remove this hardship, the waiting period for benefit eligibility should be reduced from 6 to 3 months, and eligibility should not be limited to disabilities which last more than 1 year.

The burden of unusually high medical expenses could be lifted by extending Medicare to the permanently and totally disabled.

The other major disability income program is workmen's compensation, intended to pay medical expenses and provide income for workers (and their survivors) disabled through work-related accidents and diseases. Workmen's compensation is governed by State laws which require employers to obtain insurance from private companies or a State fund, or to establish self insurance.

The present weaknesses of workmen's compensation are inadequate benefits and the exclusion of large groups of workers.

In 1966 the maximum cash benefit (including dependents' allowances) under workmen's compensation was below the poverty line for a four-person family in 39 States; over half the States have maximum benefits less than 50 percent of income prior to disability. About 11 million workers—

mostly domestics, agricultural employees, and employees of small businesses—currently are not covered at all by workmen's compensation.

Improvements in workmen's compensation ought to come through State laws. To provide an incentive for such action and to protect workers in its absence, Federal action may be required. Consideration should be given to legislation requiring States to extend coverage and to improve benefits. If States fail to act, the law might require employers to purchase insurance providing additional coverage and higher benefits.

### *Unemployment Insurance*

Unemployment insurance contributes significantly to the prevention of poverty by providing income to regular members of the labor force during periods of involuntary unemployment. Yet more than a fifth of the employed labor force are excluded, a large number of whom are in low-wage occupations such as domestic service and farm work.

The original aim of unemployment insurance was to restore at least half of wages lost. Average weekly benefits—about \$42 in 1966—are roughly a third of weekly earnings in covered industries. Most States now pay benefits for a maximum of 26 weeks in a single year; over one-fifth of the recipients exhaust their benefits, even in periods of high employment.

For a fair and modern unemployment insurance system, legislation is needed to broaden protection, ensure higher and more uniform benefits, provide special training, and eliminate abuses.

### **MAJOR REFORM**

Proposals for more fundamental reforms of the income maintenance system merit consideration along with the more evolutionary suggestions outlined above.

Major reform can be undertaken in two ways. First, the categorical approach can be expanded and improved by reforming eligibility requirements, raising benefit levels, and—in particular—adding programs for poor families headed by a working man and for other groups not now covered. Alternatively, present welfare programs could be replaced by a single universal Federal program—supplemented by social insurance—having no eligibility requirements other than low income.

### *Benefits for Poor Families Headed by Working-Age Men*

The largest omission from the present income maintenance system is a program to assist families headed by able-bodied working males who are not eligible for unemployment insurance or who have exhausted its benefits. Unconditional cash benefits to working-age men are often opposed on the grounds of possible adverse effects on work incentives. Whatever society's attitude toward fathers in poverty, failure to assist their children makes the children likely candidates for a new generation of poor. Further-

more, under the present system a father can often increase the income of his family by deserting them to make them eligible for welfare.

*Children's Allowances.* Children's allowances are systematic payments by the Government to families with children. The United States is the only Western industrialized nation without a children's allowance. The program has been adopted in some nations as a vehicle for both providing income to the poor and promoting population growth.

Children's allowances can take several forms. To channel aid effectively to the poor, the allowances have to be related to family income. If children's allowances are not income-related but go to all families, they are an exceedingly inefficient way to help the poor.

An income-related children's allowance is one method of attacking poverty among two categories of poor households—those with moderate incomes and large families and those with low incomes and average-size families.

*Guaranteed Work.* A program of guaranteed work opportunity for poor, employable fathers is especially attractive because it offers a workable compromise between those who favor income maintenance and those who favor expanded employment as a vehicle for ending poverty among these families. Fathers suffering from long term unemployment would certainly be eligible for the program. Eventually others with very low incomes might be included. Each enrollee would receive cash benefits and would be required to participate in steps—including acceptance of placement services or training—leading to private employment paying at least minimum wages. Those for whom private employment could not be found would be given meaningful public service jobs at minimum wages that provide opportunities for advancement.

The guaranteed work program could ultimately allow any man to earn the minimum wage, which at present would bring families of 4 or fewer near the poverty line. By itself, this would not solve the problem of poverty for large families. Nevertheless, the largest gap in the present income maintenance system would be closed in a manner consistent with the traditional American attitude toward welfare for able-bodied fathers.

*The Negative Income Tax.* The negative income tax would provide a minimum-income guarantee to all individuals. Benefits would be reduced by a fraction of income, as is currently the practice for AFDC mothers and individuals receiving social security.

A minimum-income guarantee would end society's attempts to distinguish between the "deserving" and "undeserving" poor, establishing the principle of social responsibility to aid those in need without questioning whether the fault was individual or social.

As a substitute for other income maintenance programs, the negative income tax is bound to be expensive. If the guaranteed income is set at or near the poverty line—and if the proportion of earnings by which benefits are reduced is low enough to provide adequate work incentives—substantial

benefits must be provided to middle-income families, swelling the cost. To illustrate, suppose the minimum-income guarantee for a family of four is \$3,300—about the income required to escape poverty in 1967. Suppose that every dollar earned reduces benefits by 50 cents—a reduction that probably approaches the maximum consistent with providing work incentives. Under this plan, a family earning \$5,000 a year would have benefits reduced by one-half of \$5,000 (or \$2,500), leaving the family eligible for \$800. All families of four with less than a \$6,600 income would receive some assistance. Adoption of this particular plan now would cost about \$20 billion over and above present income maintenance outlays; roughly half would go to families not now in poverty.

The cost can be reduced by increasing the rate at which benefits go down as income increases. But this approach would reduce work incentives. The cost could also be reduced by setting the guaranteed minimum income well below the poverty line; however, if a low-income guarantee were adopted, poverty would not be eliminated. To deal with this problem, the income guarantee could be supplemented by State—or even Federal—welfare programs for particular categories. But then attempts to distinguish between the “deserving” and “undeserving” poor would not have been eliminated.

Another way of dealing with the problem of different categories of the poor within the framework of the negative income tax is to establish separate minimum-income guarantees and benefit-rate reductions for various types of households. Again such modification would introduce complexities and reduce the appeal of the plan as simple and universal.

Nevertheless, a minimum-income plan may be acceptable both in terms of cost and of the beneficiaries served. If the guaranteed minimum income is at or close to the poverty line, and if the rate of benefit reduction is low enough to limit adverse incentive effects, the plan would meet the tests of a good income maintenance system.

The Commission on Income Maintenance has been asked to study in detail the appropriate long-run direction of policy in this area. The Commission will report at the end of this year.

## SPECIAL PROBLEMS OF POVERTY POCKETS

Poverty in the United States is unevenly distributed, both racially and geographically. Two particularly visible concentrations of poverty are big city ghettos and declining rural areas.

Many difficulties faced by residents of poverty pockets are simply virulent local outcroppings of national problems. Others are peculiar to the community in which the concentrations of poor occur. The discussion below separates the elements of poverty problems in ghettos and rural communities into those amenable to general, national solutions and those that require special programs aimed at the areas in question.

## STRATEGIES FOR ATTACKING GHETTO PROBLEMS

The most visible—and certainly most explosive—concentration of poverty is in the ghettos of large cities. Here deteriorating physical facilities, inadequate public services, low income, and high unemployment combine with high population density to create a dehumanizing, hostile environment.

The ghetto contains a concentration of people whose health, age, family status, and limited training are obstacles to full-time employment in well-paying jobs. It has vastly inferior educational and health services. These are national problems, and strategies discussed elsewhere in this chapter could produce significant rewards in the ghetto.

Other ghetto problems—and the programs required to deal with them—are unique. First, unemployment is extremely high. The Department of Labor reported that in the fall of 1966 the unemployment rate in the low-income neighborhoods of eight large cities was 9.3 percent. More striking, subemployment was an additional 23 percent.

The second problem of ghetto areas is extensive deterioration of the physical environment—housing, commercial buildings, even open spaces.

Restoration of the cities will be expensive, whether publicly or privately financed, but a large-scale facelifting of urban America offers the opportunity for a rational, coherent attack on the problems of the ghetto.

### *Fiscal Disparities Within Metropolitan Areas*

Roughly an eighth of welfare benefit costs, half of elementary and secondary education expenditures, and virtually all police, fire protection, and sanitation costs are borne by local government. Central cities, with their large concentrations of poor, have difficulty meeting these costs. The property tax base per capita is substantially higher in the suburbs than in the central cities, but suburbs collect less total tax revenue per capita and spend far less per capita on social services—health care, welfare, police, fire protection, recreation, and sanitation. Suburbs spend far more per capita (and per student) on education than does the central city. Responding to lower taxes and better educational systems, a stream of middle income families flows from the central city to suburban communities. Central cities must then cut back on services or raise taxes even higher, in either case increasing incentives to leave the city. The heavy burden of providing services to the poor thus threatens the viability of the central city.

### *Access to Employment*

The residential patterns of the poor affect their opportunities for employment. Because few lower income families can afford automobiles, their mobility is severely limited. Jobs, shopping, health care, and social contacts must all be within walking distance or accessible through inexpensive public transportation.

*Total Employment.* Most jobs are in the central cities. Even in sectors such as manufacturing, wholesale and retail trade, nonprofessional business services, entertainment, and government, with relatively more jobs in lower skill occupations, the ratio of employment to population is over 40 percent higher in the cities than their suburbs. Employment in the city is also less physically dispersed than in the suburbs, and public transportation is more readily available.

For the foreseeable future, most ghetto residents will continue to have a greater chance of finding a job in the central city. Job vacancies created by normal attrition are far more numerous than those created by entirely new positions, and consequently the number of job openings is greater in the city with its much larger total employment. Some big city ghettos—such as Watts—are isolated from the areas of greatest employment density, but Harlem and Bedford-Stuyvesant are only a few minutes on the subway from the most dense center of employment in the world. Job problems in such areas are not explained by physical isolation from sites of employment.

*Job Growth.* Most of the growth in employment is occurring in the suburbs, and job opportunities for low-income people will continue to grow there. Many ghetto residents already hold suburban jobs. A recent study of commuting patterns in Pittsburgh indicated that employed, low-income Negroes, on balance, traveled away from the central city to reach their jobs, while whites in the same employment class traveled toward the central city—and traveled fewer miles.

Access for ghetto residents to the growing number of suburban jobs can be improved by both better transportation and less discrimination in suburban housing. The transportation requirements for those taking better paying suburban jobs are greatest in the first few months of employment. After that, workers tend to buy their own cars or form car pools. Transportation needs of domestics and other low-paid workers are not so easily solved.

Suburban housing is already becoming more available to ghetto residents. Between 1966 and 1968, the number of Negroes residing in the suburbs grew by half a million, although Negroes continued to account for only about 5 percent of the suburban population. Access to suburban housing should continue to improve as the fair housing provisions of the Civil Rights Act of 1968 become effective.

### *Living Costs for the Poor*

The central city ghetto is an expensive place to live. Ghetto residents often pay higher prices for comparable merchandise and are frequently sold inferior goods. To some extent, these higher prices reflect higher selling costs resulting from smaller average purchases, increased pilferage, slower turnover of perishable items, and higher insurance rates. Easy credit, along with high-pressure salesmanship and door-to-door selling techniques, also adds

to the costs of ghetto retailers. A Federal Trade Commission study of Washington, D.C., furniture and appliance stores revealed that prices in ghetto stores averaged \$255 for each of \$100 of wholesale cost, compared to \$159 in the rest of the city. Even so, net return on investment was considerably lower than for retailers elsewhere.

If ghetto residents had greater access to general market retailers, they would pay significantly lower prices. This access requires improved transportation facilities in some cities and education—educating general retailers that low-income families can carry moderate amounts of installment credit, and educating low-income shoppers about price differentials.

### *The Role of Private Enterprise in Ghetto Development*

Reconstruction of the cities will require deeper involvement of private enterprise.

The major asset of private business is its efficiency in accomplishing specific tasks at minimum cost. The Federal Government has recognized the contribution business can make. For example, local housing authorities are now permitted to turn over much of the planning, site acquisition, and supervision of construction of public housing to private developers. This "Turnkey" policy has reduced costs and greatly cut the time required to produce public housing.

Without government inducements, profits are low in ghetto areas—a deterrent to private investment. Despite higher prices, retail business has difficulty thriving in the ghetto. Investing in new housing for low-income families—particularly in big cities—is usually a losing proposition. Indeed, the most profitable investment is often one that demolishes the homes of low-income families to make room for businesses and higher income families. Much of the blemished reputation of early urban renewal programs came from pursuing the most profitable development of renewal areas.

Many business leaders are willing to sacrifice some profits in order to invest in the ghetto, but they cannot be expected to shoulder the major part of a financial burden that is properly the responsibility of all society.

Participation by the private sector is also limited by the large scale normally needed to make a ghetto project economically viable. Costs are far lower and prospects for permanent improvement far greater if redevelopment of an entire neighborhood is undertaken in a relatively short period. Only the largest corporations are likely to be able to afford efficient renewal efforts.

Government aid to provide profit opportunities will be needed to induce significant participation by the private sector. The Federal Government can provide such aid by direct subsidies to firms willing to build under its program specifications. Alternatively, a tax credit or a deduction from taxable income could be given for a broad class of ghetto development expenditures.

Three considerations bear on the choice of the proper techniques for attracting private enterprise into ghetto reconstruction.

First, the efficiency of Federal assistance is reduced if subsidies are paid for activities that would have been undertaken anyway. Tax incentives automatically apply to all investment in the subsidized category. Even in the most depressed urban areas, some investments are still being made without subsidies.

Second, a dollar of direct expenditure and a dollar of tax incentive have identical effects upon the budget, requiring either a reduction in other Federal programs or an increase in taxes. One technique adds to Federal expenditures; the other lowers Federal tax receipts.

Finally, tax incentives are not effective for encouraging indigenous businesses. Large corporations, earning profits in other operations, benefit from tax incentives, but firms operating only in the ghetto—where profits are low—receive less benefit. New firms often receive no benefits from tax incentives since fledgling enterprises typically earn low profits. Since support of new, ghetto-owned businesses is a particularly promising vehicle for promoting ghetto development, a more direct form of assistance for these firms is necessary. Such firms need loans and management assistance as well as the subsidies that would be provided to established businesses through tax incentives.

The Federal Government has moved to assist indigenous businesses. Projects in Model Cities areas must, where possible, be constructed by labor and businesses from the “model neighborhood.” The Small Business Administration, through federally guaranteed loans and technical assistance, aided 2,300 minority-owned businesses in fiscal 1968. It plans to raise this number to 6,500 new firms in fiscal 1969 and 14,000 in fiscal 1970.

The Federal Government can also assist in establishing other social institutions. Community Action Agencies, supported by the Office of Economic Opportunity, provide a fulcrum for involving the residents of low-income areas in the revitalization of their neighborhoods. These agencies also provide a single, knowledgeable source of information on the programs available to assist the poor, as well as supplying many of these services themselves.

## **STRATEGIES FOR REDUCING RURAL POVERTY**

Over two-fifths of America’s poor live in rural communities, even though only about one-fourth of the population is rural. Rural poverty, though not as visible as urban poverty, is a major national concern.

Rural communities face two special problems. First, average family incomes in these areas are often low. Rural communities have difficulty making sufficient investments in public facilities and schools. Expansion of Federal support for income maintenance, education, and other social services for the poor would relieve rural communities of some of the burden of caring for their relatively large dependent population.

The second special problem stems from the persistent outmigration of the past half century. Migration to the city occurs largely because of declines in the principal sources of rural job opportunities—agriculture, mining, and forestry. Most migrants improved their living conditions by moving. In areas where jobs were limited and migration took place, those who stayed obtained more employment at better wages than if migration had not occurred.

A reduced rural population creates serious problems of public finance. Those who leave tend to be more employable, more highly skilled, better educated, and younger than those who remain. Some rural communities are thus left with a skilled labor force too small to support new industries. In many areas, excess capacity has developed in public facilities built for larger populations than currently exist. The cost of maintaining these facilities limits the ability of local governments to finance other public services.

Other rural communities are growing vigorously. Manufacturing employment is increasing more rapidly in the less urbanized States than in those containing large urban centers. Furthermore, from 1962 to 1966 non-farm employment grew most rapidly in the counties with the smallest population centers.

Net migration out of most rural counties is continuing, but at a slower pace than in the 1950's, particularly in the rural South and Midwest. For example, of the 100 nonmetropolitan counties in Kansas, only 7 gained in population through migration in the 1950's; 32 have done so since 1960. Annual net migration from nonmetropolitan counties in the South has fallen from 400,000 between 1950 and 1960 to 50,000 since 1960. These trends indicate that a selective rural development policy, concentrating on those counties which have begun to grow in the 1960's can produce substantial economic progress in much of rural and smalltown America.

### *The Federal Role In Rural Communities*

Federal aid for education, planning, and public facilities overcomes barriers to future development arising from the low income of rural communities. Title I of the Elementary and Secondary Education Act provides funds to defray part of the costs of education in areas with high concentrations of poverty. About 30 percent of these funds go to rural areas.

The Federal Government has also taken an active role in promoting areawide planning in rural areas. Forty million Americans reside in seven areas served by Regional Action Planning Commissions established under the provisions of the Public Works and Economic Development Act. These agencies help to plan over-all regional economic development and to coordinate Federal, State, and local community assistance.

The Department of Agriculture provides technical assistance to private and public groups in rural areas undertaking coordinated planning and de-

velopment activities. Loans, grants, and technical aid to low-income rural areas from the major Federal Departments amounted to over \$1 billion in fiscal 1968.

### *Diversification of the Rural Economy*

Since economic development programs are more effective if some growth has already taken place, Federal rural development assistance should be oriented toward more densely settled "growth centers," such as smaller growing cities or small metropolitan areas. With a population of viable size, a community can diversify its economy and cushion itself against employment fluctuations in one industry. As more firms settle in an area, they interact with mutual benefit by forming a sufficient market for the growth of business services and of cheaper communications and transportation—increasing the attractiveness of the community for further business development.

This strategy has largely been adopted by the Department of Agriculture and the Economic Development Administration in aiding depressed, non-metropolitan regions. In addition, Federal agencies should give explicit consideration to the development effects of Federal installations. Military bases and scientific installations, for example, have a profound effect on the community in which they locate.

Some rural communities, suited only for traditional resource-based industries, will continue to decline. The Federal Government should ensure that the remaining population is not required to carry the whole burden of declines in the industries many rural communities have depended upon. Adequate income maintenance, support for education, and federalization of other costs associated with economic and population decline are the most equitable steps that can be taken to assist these areas. Federal support for the costs of moving low-income individuals to employment opportunities elsewhere is also desirable in certain situations. Job training and job location services are also needed to help both migrants and those who remain. These last two measures are discussed in Chapter 3.

## FULFILLING THE NATIONAL COMMITMENT

With a "poverty gap" of slightly more than 1 percent of GNP, the United States can—if it will—rapidly reduce poverty. This effort will require that the incomes of the poor grow faster than average income. Otherwise, conquering poverty will take a long time indeed.

The long-run objective should be to reduce dependency, as well as poverty. To this end, education and training will be required so that all Americans can qualify for a decent job. In addition, programs are needed to expand employment opportunities in poverty pockets. But many of these efforts will take years to become fully effective.

To meet the most pressing income needs of the poor promptly, expansion of income maintenance is required. Welfare and social insurance programs have brought us a long way in combating poverty among the covered groups; further benefit increases can close the poverty gap among those covered.

The most difficult policy issues pertain to families headed by an able-bodied man, for whom no major income support programs now exist. Most of these men now work but with insufficient earnings to take their families—particularly large families—out of poverty.

Maintaining high employment is essential to eliminating poverty among families headed by a working man. Continued prosperity will raise the incomes of some of these men above the poverty line. For the rest, a desirable policy could be compounded out of job training, placement, income support, and public employment. The poverty gap in 1967 for these families—containing 10.7 million persons—was \$2.7 billion. The actual costs of a program to assist this group would exceed this amount. Supplementary employment services and, for reasons of equity and work incentive, some benefits for the near-poor, would have to be provided.

Federalization of more of the costs of providing the poor with welfare, education, health care, training, and public facilities would spread the costs of combating poverty more equitably. Caring for the poor now places a severe financial burden on communities with concentrated poverty.

The choice as to how poverty will be eliminated has begun to enter into public discussion and debate. A number of good alternatives are available. After appropriate and intensive deliberation, the American public must find mechanisms for effectively attacking poverty—mechanisms and programs that can command widespread support. The success of any program is jeopardized if assistance is handed out begrudgingly and becomes demeaning to the recipients. Beyond this, the most essential requirement is a program of a scale adequate to guarantee *rapid progress* toward ending poverty.

Fulfilling the Nation's commitment is far more important than the details of the precise tactics used.