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THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

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pg. 3! Justification of tax hike
as primary means to fight inflation
March 12, 1966

MEMORANDUM FOR THE PRESIDENT

Subject: The Economics of a Tax Increase

* Joint Economic Committee

1. Decisions on further tax measures for 1966 require hard political and economic judgments. Concentrating only on the economic aspects, this memorandum summarizes the argument

- that a further tax increase is needed to counter inflation;
- that the more promptly it can be announced, the better its effects will be, even if specific proposals are delayed;
- that the announcement will counter inflationary expectations more effectively if it is not tied to new increases in defense expenditures.

2. The economy is breaking all reasonable speed limits today. During most of last year, our gains were well-paced. But since September when the Vietnam era really took hold, we have been moving ahead at breakneck speed.

- In the four months, September to January, industrial production rose 4-1/2%, and it apparently advanced another 1% (or a little more) in February. (By comparison, in the five-month period, April-September 1965, it rose 2%.) Operating rates in manufacturing this quarter average 92%; they are likely to set a new post-Korean record and are getting close to the Korean War highs.
- In the past 5 months, nonfarm payroll employment has increased by an average of 330,000 per month. A good normal prosperity increase would be about 150,000 a month.
- February's 3.7% unemployment rate was the lowest since Korea. The rate has dropped 0.7 points in the past five months compared with the decline of 0.4 points in the preceding five months.

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- Prices have also been moving up more rapidly. From September to January, wholesale industrial prices rose 0.8% or a 2-1/2% annual rate, about double the rate of increase in the first 9 months of 1965. Except for food, consumer prices have been reasonably well behaved. But excise tax cuts provided temporary and nonrecurrent relief. Sharper increases at the consumer level must be expected as some of the recent increases in wholesale material prices pass through to the consumer level.
- 3. No let-up is in sight on the advance of demand. Each month we dip further into our slim remaining reserves of unused manpower and machines. A continuation of the recent pace would mean general shortages by mid-year. The huge inflow of new and less skilled workers must hold down productivity gains. Wage increases are being stepped up in unorganized sectors where guideposts have no meaning. When nonunion workers get big gains, it becomes even tougher to ask the unions to stay in line. Every week difficult-to-revise investment commitments are being made on the assumption of sky-rocketing demand. This means that the needed tax increase may get larger the longer we wait.
- 4. Our other actions on the price front are weakened by the absence of fiscal support. Sellers do not yet feel overwhelmed by demand pressures they cannot meet. But many feel that, without fiscal support, "jawbone" measures can't work, and that it's wrong to fight inflation by "attacking only the symptoms." Also, there is Bill Wirtz' point that people will cooperate better if they feel everyone is being asked for sacrifices.
- 5. Our Economic Report set forth an outlook for 1966 that would not call for fiscal action beyond the present bill. It involved
 - a GNP of \$722 billion, matching the dollar increase of 1965;
 - a reduction in unemployment to a 3-3/4% average for the year; and
 - a rise in over-all prices of less than 2%, repeating the performance of 1965.
- Every business and financial economist in the country now forecasts GNP as well above \$722 billion. We can't maintain credibility with our old forecast.

- . It is easy to see why this is no longer a tenable position. Unemployment in February was where we said it would be around mid-year. The new plant and equipment figures alone would support a GNP close to 730. Prices are clearly moving up faster than last year, and could reach the 1956-57 rate of advance later this year.

- 6. We are not facing an explosive situation. A little inflation won't be fatal. But inflationary psychology and inflationary symptoms are taking root. If they do get firmly established, it will be hard to uproot them, and hard to resist pressures for overly-restrictive action.

- 7. Taxes are the main line of defense, because
 - The Fed can't make money sufficiently scarce without making it fantastically expensive;
 - the Budget is already tight; while cutbacks should accompany a tax hike, they are bound to be limited;
 - guideposts can't be expected to carry the major load in an overheated economy.

- . When demands were below our productive capacity, the 1964 Revenue Act yielded tremendous benefits by leaving more purchasing power in private hands and thus bringing demand up to balance supply.

- . Now the situation is reversed. Siphoning off some purchasing power would help greatly to hold demand down in line with our productive capacity.

- . It is generally recognized that the tax cut worked in 1964. A tax increase would generally be expected to work in 1966.

- 8. Hence, if you announced soon a decision that you would ask for a tax increase later this spring, it would have some immediate stabilizing effect. Explicit rejection of an excess profits tax and of direct controls would also help.

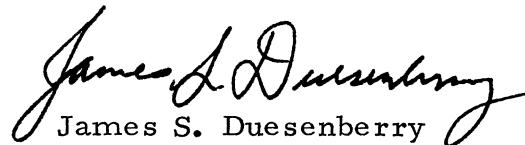
- . Expectations would be steadier and businessmen would have less reason to scramble for goods.

- Money markets would respond favorably. While the stock market would have to count on lower after-tax profits, it would probably stay on a more even keel and would welcome the reduction of uncertainty.
 - Thus, "the sooner the better" is the economic principle on timing any announcement, even if the effective date of the actual tax increase were to be as late as July 1.
9. Coupling the announcement of a tax increase with an increase in defense expenditures would have less dampening effect on inflationary expectations. It would imply that the government was going to take away purchasing power with one hand, and put it right back into the economy with the other. Thus, there is a strong economic argument against coupling a tax hike with a Vietnam supplemental. (If a Vietnam supplemental became necessary later this spring to support a higher actual rate of defense spending, the amount of the tax increase requested could then be stepped up.)
10. Obviously, the Administration cannot do a 180-degree turn overnight. But you laid a good basis for further tax action with strong statements about the need for flexibility in your State of the Union Message, Budget, and Economic Report. We could build on this foundation by gradually indicating an increased determination to take action before inflation takes hold.
- Informed opinion can help lay the base. Right now, the only economists opposing a tax increase are a small minority of labor union types (who just don't give a damn about inflation) and a few reactionaries on the other extreme (who want a big budget cutback). ✓
 - Some of our friends on the outside -- Walter Heller, Kermit Gordon, and possibly Doug Dillon -- have pulled their punches in order to avoid possible embarrassment to the Administration. But at this point there might be an advantage in having more people climb on the tax-increase bandwagon to persuade Congress. When the JEC holds hearings next week, they will get an earful of tax-hike advice from the experts.

11. There is only one serious issue concerning the form that a tax increase should take. That involves the investment credit.
- Investment spending is the sector giving us the most trouble, and temporary suspension of the investment credit is a rifle shot technique for postponing investment demand to a time when we will need it. On the other hand, Joe Fowler has serious problems in reversing his personal promise to businessmen that this would be a permanent measure.
 - Apart from this, there is general agreement on an across-the-board personal and corporate rate increase of a simple form.
 - We'd like to put all the evidence together before recommending the precise amount of a tax hike, but something in the range of \$4 to \$7 billion ought to do the job, unless defense spending will rise a lot. This would be only a small fraction of the 1964 tax cut. Counting excise tax reductions, you would still be responsible for net cuts of at least \$10 billion.


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