pg 3: Link between monetary and fiscal policy

August 9, 1966

MEMORANDUM FOR THE PRESIDENT

Subject: An Immediate Tax Program

You asked yesterday what kind of tax program I would suggest that you propose, if you were to propose one at this time. It seems an academic exercise -- especially after yesterday's bipartisan leadership meeting. But here it is.

1. We are still attracted by the fair-shares logic of the surcharge approach for corporate and individual income taxes. This adds the same percentage increase to the tax bill of every firm and person. If the surcharge is 10%, then a $100 tax bill rises by $10, and one of $100 million rises by $10 million.

2. Because profits have risen more than wage incomes, and because bloated profits are such inviting targets for excessive wage demands, a case can be made for a tax hike which hits harder on profits. But a straight profits tax hike is not very effective in curbing demand. So a billion of extra corporate tax increase can't substitute for a billion less of individual tax increase. Moreover, the real reason for doing it -- to try to buy labor's cooperation -- can hardly be stated baldly.

3. Suspension of the investment credit offers a way to put an extra bite on corporate profits while maintaining an equal-treatment, fair-shares approach on basic income tax rates for individuals and corporations. Suspension of the investment credit has the special justification that it would be fairly effective in curbing investment demand. Thus it would directly relieve pressures on the machinery and equipment industries, where our supply capabilities are most seriously strained.

4. On economic grounds alone, the ideal surtax -- combined with suspension of the investment credit -- would probably be at least 10% (assuming budget expenditures of $120 - 122 billion). But it might be shaved to 8%.

- An 8% surcharge on personal and corporate income taxes and a full suspension of the investment credit would siphon off nearly an extra $10 billion as soon as it took effect (probably October 1).

. Here is the way it would add up:

	Billions of $ (annual rate)
8% surcharge on personal income taxes	5.0
8% surcharge on corporate income taxes	2.7
Suspension of investment credit	2.0
Total	$9.7

. Because of the extra $2 billion from suspension of the investment credit, the package adds about 13% to corporate taxes as compared with its 8% increment to personal taxes. Another way of looking at it is that, although corporations pay only a little more than one-third of existing income taxes, they would pay nearly half of the increase in taxes.

5. If it should be impossible to get the investment credit suspended, then we should seriously consider a heavier surtax on corporate profits. Its function would be to buy labor cooperation. But it would seem necessary to strike a fairly explicit bargain with labor if we go this route. There's no use giving this away without getting something in return. Another possible element in such a bargain would be to exempt the lowest income groups from any tax hike.

6. Any tax proposal would have to be accompanied by a new appraisal of defense expenditures, which officially put on record the obvious fact that we are going to have to spend more for defense in fiscal year 1967 than last January's Budget estimated.

. This doesn't necessarily require asking for a supplemental -- we don't need more funds now, and we can estimate the exact amount better in January.

. Asking for the supplemental now would tie the tax package more definitely to Vietnam, and this cuts two ways. Once Congress voted to approve the supplemental, it could hardly be so irresponsible as to vote against the related tax action. On the other hand, the supplemental might complicate foreign policy issues by provoking a more serious Vietnam debate.

7. Something new and dramatic on nondefense expenditures should be an ingredient in the package. Candidates might include a freeze on Federal nondefense employment, a commitment to veto swollen appropriations, or a substantial list of public construction stretch-outs.

8. This program should assure a surplus in the Administrative Budget for fiscal year 1967. But rather than stretch for a big surplus, we would advise operating just a little in the black so as to leave room for a possible trimming of our participation sales. Our present schedule of participation sales could tighten money unduly. Also, we are building up for a big letdown in corporate tax receipts in fiscal year 1968. We might try to prepare for this by saving some participation sales for 1968. (Participation sales do help the budget, but have little if any restraining effect on the economy.)

9. I believe we could and should get the Fed on record promising to adjust the monetary policy screws (and especially help to relieve the mortgage famine) in return for a new fiscal program. Congress needs to be reminded that we can have a less restrictive monetary policy, but only by adopting a more restrictive fiscal policy.

Gardner Ackley