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THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

August 17, 1966

MEMORANDUM FOR THE PRESIDENT

Subject: Investment Tax Credit

1. Art Okun and I talked today with Wilbur Mills about the investment credit. We found him

   -- in agreement with our view that it should be suspended; ("You don't have to convince me");

   -- entirely optimistic about the chances of passing a suspension bill.

   "Just have the President tell me he wants it, and we'll go to work."

2. I therefore renew my recommendation that you seek suspension in the present session. This could be done either

   -- as a separate proposal, divorced from anything else; or

   -- as part of a larger (though still interim) stabilization package such as, for example, Dave Ginsburg has recommended.

3. One big problem would be to get Joe Fowler and his troops really on board. There is a lot of technical work that would need to be done that only Treasury can handle. Joe would be much more enthusiastic if this were part of a larger stabilization package that also included some overt action on expenditures. I certainly support Joe's view on the acute need for something fairly bold on the expenditure front.

4. As you know, almost all economists inside and outside the Government support the suspension. Kermit Gordon feels particularly strongly on it, as do Walter Heller, Paul Samuelson, Joe Pechman, and Arthur Burns. I haven't talked recently with Jack Connor, but he previously favored it. So do the Federal Reserve, labor, the Republican minority on the House Banking and Currency Committee, the Joint Economic Committee majority (the minority hedged). Wilbur said he understood there would be a heavy majority in the Senate.

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ON DESK

From the desk of . . .

8/17/66

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GARDNER ACKLEY, Chairman
Council of Economic Advisers

The President --

A report on my conversation with Wilbur Mills.

Contrary to the impression you got last night, Wilbur hadn't been stalling me off. Rather, I had to cancel out several times because of crises or rush jobs.

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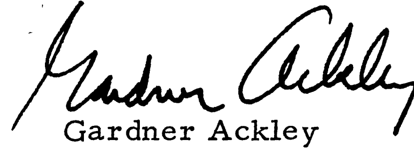
5. Right now, it could draw a lot of support from the anti-tight money sentiment. The strongest force driving up interest rates today is the insatiable demand for credit to finance new investment.

6. I attach a CEA staff study that summarizes the case for suspension.



Gardner Ackley

Attachment

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CEA Staff Paper
8/10/66

Too Much of a Good Thing: Why the Investment Credit Should be Temporarily Suspended

A. Summary

Temporary suspension of the 7% investment tax credit would be an important constructive step in combating inflationary pressures. The vigor of investment demand in recent years has been gratifying. But investment is now too high for the welfare of the economy. We are getting too much of a good thing. Suspending the credit would promptly and directly moderate investment demand. For the very reasons that the investment credit has been such an effective stimulus and was such a wise innovation in 1962, its temporary suspension would offer great benefits in the emergency situation of 1966. These benefits would far exceed the $2 billion annual revenue impact, for this is a measure with a particularly large bang-for-a-buck.

Some of the evidence underlying these conclusions is set forth below.

B. Inflationary Pressures in the Machinery Industries

Machinery and equipment industries are the most seriously strained area of the economy. Inflationary pressures are intensifying. They will keep growing as long as the capital spending boom continues. As businessmen scramble for more capital goods, machinery and equipment

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producers will increasingly respond with higher prices rather than higher production.

Manufacturers of machinery simply cannot produce enough to keep pace with their inflow of orders. Order backlogs for machinery have grown 29% in the past 12 months, 14% in just the past 6 months. Unfilled orders have increased every single month.

There is an acute shortage of skilled workers in machinery manufacturing. The unemployment rate in the nonelectrical machinery industry was down to an amazingly low 1.9% in the second quarter. The average workweek of 44.0 hours was the longest in any manufacturing industry. The press is full of reports on steps that firms have to take to deal with their labor shortages -- bonuses are given to employees who bring in new workers; job applicants are offered guarantees of at least 8 overtime hours a week; women are being recruited for jobs which have traditionally been labeled "for men only."

The Bureau of Labor Statistics reported this week: "A handful of occupations account for two-thirds of the hard-to-fill jobs -- machinists, machine shop workers, mechanics and repairmen, welders, toolmakers and die sinkers, and pattern and model makers." Last month BLS reported: "The machine tool industry continues to reflect one of the tightest manpower situations in the country. Shortages of metal working skills have been plaguing the industry for over a year. Some machinery

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manufacturers report that hiring at lower skill levels is being hampered by unavailability of higher skilled supervisory workers."

Prices are spurting as the result of the very tight supply situation. Electrical machinery prices have risen at a 4% annual rate so far this year, reversing a long downward trend that persisted through 1965. Prices of metal-working machinery have risen at an alarming 7% annual rate in the first 7 months of this year.

C. Sustainability of Investment

The present investment boom is not sustainable. Current investment rates are expanding capacity too rapidly for the long-term needs of the economy, setting the stage for a possible decline in the future.

For the third straight year, business fixed investment is rising twice as fast as GNP; the plant and equipment sector is not in balance with the rest of the economy. Business fixed investment is approaching 11% of GNP. In no previous postwar year has it exceeded 10-1/2%; it can not be expected to stay significantly above 10%. Manufacturing capacity will grow more than 7% this year. Over the long run, manufacturing output cannot be expected to advance more than 5% a year.

D. Balancing Costs and Benefits

Plant and equipment spending cuts two ways in its inflationary impact: it adds to demand and thus to inflationary pressures while the capital goods are being built; on the other hand, it adds to supply and

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relaxes inflationary pressures by providing more and better capacity once the new capital goods are put into operation. But the two sides do not balance out in our present situation. The cost of a slightly reduced growth of capacity is far less than the benefit of moderated demand for several reasons.

In the first place, a cooling-off of investment demand would not reduce the production of capital goods significantly; rather it would slow down the price increases and hold down the order backlogs for machinery and equipment. Secondly, even if the production of capital goods is held down somewhat, this would make only a relatively slight difference in the growth of capacity over the months ahead. The fact that a long-lived capital good takes several years to pay for itself should remind us that its contribution to supply in any short period is substantially less than the cost of the resources used in producing it. This is true for the economy as well as for the investing firm. A cut-back in investment sufficient to moderate the level of industrial production by 1% in the first quarter of 1967 would hold down our industrial capacity at that time by no more than 0.2%. Thus, the net result would be a clear gain: the average industrial operating rate would be lower by 0.8%, and demands for skilled labor would be moderated.

E. Prospects for Investment

Investment demand is still booming. The latest surveys of business

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plans still point onward and upward. Upward revisions in plant and equipment spending plans are still the rule of the day. There is virtually no evidence that tight money has stopped corporations from launching capital projects. The response to the President's appeal for restraint helped, but it was swamped by other forces that pushed investment up.

Business will continue to enjoy rising profits and cash flow, growing sales and profits, and peak operating rates. Businessmen will have equally strong incentives to expand their capital outlays in 1967 as they have had this year, unless some policy action is taken to cool things off.

F. Other Effects of the Capital Boom

The capital boom is having unfavorable consequences in a number of areas. Adverse ripples are being felt in shortages, tight money, and the balance of payments.

Shortages and price pressures in metals are a reflection of the capital boom. Tight money is another consequence. The tremendous demands for funds to finance investment projects is the principal cause for the present tightness of credit. To be sure, the Federal Reserve could have fed all of these tremendous demands. But it would then have served as an engine of inflationary credit creation. The feast in business investment spending, and in borrowing to finance it,

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has caused a famine in the mortgage and homebuilding markets. Cooling off investment demand would help to redistribute funds more equitably.

The capital boom has direct adverse effects on our balance of payments. Imports of machinery and equipment have jumped as businessmen found that they would have to wait in line for months to get their machinery and equipment orders filled by U. S. producers. Meanwhile, our exports have lagged as U. S. businessmen have given priority to domestic orders. This is most clearly the case in the machine tool industry; foreign orders have been going up strongly this year, but shipments to abroad are dropping sharply. The foreign orders are being put on the bottom of the pile so that domestic orders can be filled.

G. Effects of Suspending the Credit

The suspension of the investment tax credit is a rifle-shot technique ideally suited to curb excess demand for capital goods. For the same reason that the investment credit has worked so effectively as a stimulus, its suspension would be a highly effective sedative.

The suspension would work directly on capital demand by curbing the incentive to invest. A temporary suspension would offer particularly strong incentives to stretch out and defer capital projects until the

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credit was restored. This would help to raise investment demand in the future when it will be welcome.

Suspension of the investment credit would operate promptly. The economy would feel the moderating effect as soon as businessmen adjusted the flow of new orders for equipment, trucks, machines, etc. This should take only a couple of months.

Action on the investment credit would demonstrate determination to fight inflation. It would have broad support. Even among businessmen who would lose money as a result of the suspension, many concede that it is sensible economic policy. The financial community would offer its full support to such a measure. Labor would be enthusiastic. Expert opinion would line up behind the proposal, ranging all the way from Arthur Burns to Walter Heller and Paul Samuelson. The Republican minority of the House Banking and Currency Committee specifically proposed suspension of the investment tax credit recently. In view of the consensus, businessmen could hardly view suspension as an anti-business action of the Administration or the Democratic Congress.

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