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OFFICE OF THE DIRECTOR

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May 11, 1966

MEMORANDUM FOR THE PRESIDENT

Subject: The effect of a Tax Increase

In looking at the economic justification for a tax increase, there are two major issues:

First

On the best possible forecast of Government and private spending, will there be serious inflation without a tax increase?

Second

Since even the best forecast is bound to be uncertain, could a tax increase lead to recession if circumstances changed -- a settlement in Vietnam, for example?

1. On the best current forecast, serious inflation is almost certain unless taxes are raised.

We now estimate that Federal expenditures in FY 1967 may be $8 billion higher than shown in the January budget -- $121 billion rather than $112.8 billion. This assumes a $6½ billion increase in Defense spending* and a conservative $1½ billion Congressional add-on to other programs.

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* The Defense estimates are our own and do not represent a conclusion of Bob McNamara. We believe the estimates are realistic -- barring a quick settlement in Vietnam.

The April Troika forecast, which assumed only a $4 billion rise in Federal spending above January budget estimates showed:

- GNP rising by 8.5% during 1966
- unemployment dropping to almost 2½% by mid 1967
- "intense and mounting" price pressures.

With an $8 billion rise in Federal spending, the forecast of inflationary problems is even more serious

- GNP would rise by 9.3% over the next 12 months, and unemployment would fall below 2½%
- a true wage-price spiral would develop
- the balance-of-payments drain could become highly alarming
- monetary tightness would surely increase, and there would be the possibility of a serious liquidity crisis in some areas, particularly among savings and loan institutions.

In 1966 consumer prices will probably rise by more than 3%. Some wage contracts are up for renewal this year (the electrical workers, some telephone workers). In 1967 a much larger number are open (autos, apparel, rubber, meat-packing, food products).

With the $8 billion added expenditures and no tax increase

- prices will rise sharply in late 1966
- there will be a severe labor shortage in late 1966 and early 1967.

Under these conditions wage settlements will be very large. In turn this will guarantee continued sharp price rises throughout 1967 and well into 1968 regardless, almost, of whether there is a 1967 settlement in Vietnam.

2. Uncertainty over events in Vietnam is not sufficient reason to prevent a tax increase.

On our best estimates, 1967 Defense expenditures will be $64 billion compared to $54 billion this year. DOD will, very soon, have to begin buying long lead-time items for use in Vietnam in fiscal 1968. Even if a settlement is reached by the end of this calendar year, a large part of the orders which precede the 1967 expenditures will, nevertheless, already have been made. Consequently, if the war continues for as little as five to six months, the basic forecast made above would be mainly correct -- and a tax increase lasting at least through early 1967 is justified.

The only situation, therefore, which might call into question the wisdom of a tax increase is a cessation of hostilities in the next five to six months. It will take at least a month to prepare and enact a tax increase. We can always reverse ourselves if a settlement is reached before the tax increase is passed. Therefore the period of uncertainty is narrowed to four or five months -- i.e., the possibility that a settlement might be reached between July and November or December.

In short, under almost every conceivable circumstance -- except a Vietnam settlement between July and November -- a decision to raise taxes at least for the remainder of this year and early 1967 is clearly warranted. And even under that circumstance, the risks of serious inflation, in my view, far outweigh the dangers of having a tax increase extend a few months past the date of a possible Vietnam settlement. 1966

The effect of a 10% tax increase plus a suspension of the investment credit and liberalized depreciation on buildings.

This tax package would:

1. Hold down the increase in consumer spending and also indirectly slow investment in consumer goods industries.

2. Directly reduce the increase in plant and equipment spending.

3. Reduce the inflationary demand, by mid 1967, to the tune of $15 to $20 billion.

4. Thereby bring total demand more closely in line with the growth in output.

5. Reduce the rise in the CPI this year and the severe labor shortage which would be facing us in late 1966 and early 1967.

6. As a consequence, hold down the size of wage settlements in late 1966 and 1967, and, therefore, sharply moderate the subsequent price inflation.

7. Slow down the rise in imports which is hurting our balance of payments.

8. Have a more immediate psychological impact which would

   - reduce the strain of excessive plant and equipment orders immediately. (If investors realized that the credit would remain suspended for only 1 or 2 years, they would have a very strong incentive to postpone investment projects till then. When Vietnam hostilities ceased, a reinstatement of the credit would be very useful to get investment expansion going strongly again.)

   - slow or stop speculative price increases

   - keep the monetary situation from becoming even tighter and, among other things, make it much easier to sell our financial assets

   - help avoid a really serious worsening of our balance of payments in the coming months.

The combination of a 10% increase in corporate taxes and a suspension of the investment credit and the suspension of liberalized depreciation might well place a disproportionate burden on business.

Further study of this may well suggest a tax package which has a somewhat smaller overall effect on business firms.

Charles L. Schultze

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