Economic Report of the President

Transmitted to the Congress
January 1962

TOGETHER WITH
THE ANNUAL REPORT
OF THE
COUNCIL OF ECONOMIC ADVISERS

UNITED STATES GOVERNMENT PRINTING OFFICE
WASHINGTON 1962
LETTER OF TRANSMITTAL

THE WHITE HOUSE

Washington, D.C., January 20, 1962

The Honorable the President of the Senate,
The Honorable the Speaker of the House of Representatives.

Sirs: I am presenting herewith my Economic Report to the Congress, as required under the Employment Act of 1946.

In preparing this Report, I have had the advice and assistance of the Council of Economic Advisers, who, in turn, have had the assistance of members of the Cabinet and heads of independent agencies.

Together with this Report, I am transmitting the Annual Report of the Council of Economic Advisers, which was prepared in accordance with Section 4(c) (2) of the Employment Act of 1946.

Respectfully,

[Signature]

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To the Congress of the United States:

I report to you under the provisions of the Employment Act of 1946 at a time when

—the economy has regained its momentum;
—the economy is responding to the Federal Government's efforts, under the Act, "to promote maximum employment, production, and purchasing power;"
—the economy is again moving toward the central objective of the Act—to afford "useful employment opportunities, including self-employment, for those able, willing, and seeking to work."

My first Economic Report is an appropriate occasion to re-emphasize my dedication to the principles of the Employment Act. As a declaration of national purpose and as a recognition of Federal responsibility, the Act has few parallels in the Nation's history. In passing the Act by heavy bipartisan majorities, the Congress registered the consensus of the American people that this Nation will not countenance the suffering, frustration, and injustice of unemployment, or let the vast potential of the world's leading economy run to waste in idle manpower, silent machinery, and empty plants.

The framers of the Employment Act were wise to choose the promotion of "maximum employment, production, and purchasing power" as the keystone of national economic policy. They were confident that these objectives can be effectively promoted "in a manner calculated to foster and promote free competitive enterprise and the general welfare." They knew that our pursuit of maximum employment and production would be tempered with compassion, with justice, and with a concern for the future. But they knew also that the other standards we set for our economy are easier to meet when it is operating at capacity. A full employment economy provides opportunities for useful and satisfying work. It rewards enterprise with profit. It generates saving for the future and transforms it into productive investment. It opens doors for the unskilled and underprivileged and closes them against want and frustration. The conquest of unemployment is not the sole end of economic policy, but it is surely an indispensable beginning.

The record of the economy since 1946 is a vast improvement over the prolonged mass unemployment of the 1930's. The Employment Act itself deserves no small part of the credit. Under the mandate and
procedures of the Act, both Congress and the Executive have kept the health of the national economy and the economic policies of the Government under constant review. And the national commitment to high employment has enabled business firms and consumers to act and to plan without fear of another great depression.

Though the postwar record is free of major depression, it is marred by four recessions. In the past fifteen years, the economy has spent a total of seven years regaining previous peaks of industrial production. In two months out of three, 4 percent or more of those able, willing, and seeking to work have been unable to find jobs. We must do better in the 1960's.

To combat future recessions—to keep them short and shallow if they occur—I urge adoption of a three-part program for sustained prosperity, which will (1) provide stand-by power, subject to congressional veto, for temporary income tax reductions, (2) set up a stand-by program of public capital improvements, and (3) strengthen the unemployment insurance system.

These three measures will enable the Government to counter swings in business activity more promptly and more powerfully than ever before. They will give new and concrete meaning to the declaration of policy made in the Employment Act. They will constitute the greatest step forward in public policy for economic stability since the Act itself.

As the Employment Act prescribes, I shall in this Report review “economic conditions” in the United States in 1961 and “current and foreseeable economic trends in the levels of employment, production, and purchasing power;” set forth “the levels of employment, production, and purchasing power obtaining in the United States and such levels needed to carry out the policy” of the Act; and present my economic program and legislative recommendations for 1962.

**Progress in 1961**

Last January the economy was in the grip of recession. Nearly 7 percent of the labor force was unemployed. Almost one-fifth of manufacturing capacity lay idle. Actual output was running $50 billion (annual rate) short of the economy’s great potential. These figures reflected not only the setback of 1960-61 but the incomplete recovery from the recession of 1957-58. The task before us was to recover not from one but from two recessions.
At the same time, gold was leaving the country at a rate of more than $300 million a month. In the three previous years, the Nation had run a total deficit of $10 billion in its basic international accounts. These large and persistent deficits had weakened confidence in the dollar.

In my message to the Congress on February 2, I stated that this Administration's "realistic aims for 1961 are to reverse the down-trend in our economy, to narrow the gap of unused potential, to abate the waste and misery of unemployment, and at the same time to maintain reasonable stability of the price level." In a message on the balance of payments on February 6, I added a fifth aim, to restore confidence in the dollar and to reduce the deficit in international payments.

These five aims for 1961 have been achieved:

1. The downtrend was reversed. Gross national product (GNP) grew from $501 billion (annual rate) in the first quarter to a record rate of $542 billion in the last quarter. In July, industrial production regained its previous peak, and by the end of the year it showed a total rise of 13 percent.

2. These gains brought into productive use nearly half the plant capacity which was idle at the beginning of the year. The growth of GNP narrowed the over-all gap of unused potential from an estimated 10 percent to 5 percent.

3. Unemployment dropped from 6.8 to 6.1 percent of the labor force. The number of areas of substantial labor surplus declined from 101 in March to 60 in December.

4. Price stability has been maintained during the recovery. Since February, wholesale prices have fallen slightly, and consumer prices have risen only one-half of 1 percent.

5. Confidence in the dollar has been restored. Our gold losses were cut from $1.7 billion in 1960 to less than $0.9 billion in 1961. The deficit in 1961 in our basic international transactions was about one-third as large as in 1960.

The "Program To Restore Momentum to the American Economy" which I proposed to the Congress on February 2 resulted in prompt legislation to

- extend unemployment insurance benefits on a temporary basis;
- make Federal aid available, through the States, to dependent children of the unemployed;
- liberalize social security benefits;
- promote homebuilding under the Housing Act of 1961;
- raise the minimum wage and extend it to more workers;
—provide Federal aid under the Area Redevelopment Act, to revitalize the economies of areas with large and persistent unemployment.

Prompt executive action was taken to accelerate Federal purchases and procurement, highway fund distributions, tax refunds, and veterans’ life insurance dividends. The Administration raised farm price supports, expanded the food distribution program, and established eight pilot food stamp programs.

Monetary and credit policies responded to the dual demands of economic recovery and the balance of payments. On the one hand, the Federal Reserve System maintained general monetary ease; Federal Reserve open market operations, complemented by Treasury management of the public debt and of government investment accounts, assured an ample supply of credit which served to counter upward pressures on long-term interest rates; reduction of FHA ceiling rates, supported by FNMA mortgage purchases, eased mortgage credit and stimulated homebuilding; and the Small Business Administration made its credit more widely available at lower cost. On the other hand, both monetary and debt management policies countered downward pressures on short-term rates, with a view to checking the outflow of funds to money markets abroad.

The Federal Budget played its proper role as a powerful instrument for promoting economic recovery. The measures to relieve distress and restore economic momentum expanded purchasing power early in the year. Subsequently, major increases in expenditure for national security and space programs became necessary. In a fully employed economy, these increases would have required new tax revenues to match. But I did not recommend tax increases at this point because they would have cut into private purchasing power and retarded recovery.

The increase of GNP—$41 billion (annual rate) from the first to the fourth quarter—reflected increased purchases of goods and services by consumers, business, and governments:

—Consumers accounted for nearly half. As household incomes rose, consumer expenditure expanded by $18 billion.

—Residential construction and business expenditures for fixed investment responded promptly to the recovery and to favorable credit conditions. By the end of the year, they had risen by $8 billion.

—Business stopped liquidating inventories and started rebuilding them. This shift, which occurred early in the year and helped get recovery off to a flying start, added $8 billion to the demand for goods and services by the fourth quarter.
—Federal, State, and local government purchases rose by $8 billion.
— Although exports were somewhat higher in the fourth quarter than in the first, the rise in imports in response to recovery lowered net exports by $1 billion.

Labor, business, and farm incomes rose as the economy recovered. Wages and salaries increased by $19 billion (annual rate) from the first quarter to the fourth. Corporate profits after taxes recovered sharply, receiving about 15 percent of the gains in GNP. With the help of new programs, farm operators’ net income from farming increased from $12 billion in 1960 to $13 billion in 1961, and net income per farm rose by $350. The after-tax incomes of American consumers increased by $21 billion, or $92 per capita, during the year. Since consumer prices rose by only one-half of 1 percent, these gains in income were almost entirely gains in real purchasing power.

One million jobs were added by nonagricultural establishments during the expansion. But employment did not keep pace with production and income. Productivity rose rapidly as capacity was more fully and efficiently utilized. And more workers on part-time jobs were able to work full time.

The record of 1961 demonstrated again the resiliency of the U.S. economy with well-timed support from government policy. Business responded to the expansion of purchasing power by producing more goods and services, not by raising prices. Indeed, the record of price stability in three quarters of expansion was better than in the three preceding quarters of recession. The rates of advance of production and income compared favorably with the two preceding periods of expansion. Production grew rapidly without straining capacity or encountering bottlenecks.

As 1961 ended, actual output was still $25 to $30 billion short of potential, and unemployment was far too high. But much of the industrial manpower, machinery, and plant that lay idle a year ago had been drawn back into productive use. And the momentum of the 1961 recovery should carry the economy further toward full employment and full production in 1962.

GOALS OF ECONOMIC POLICY

Though we may take satisfaction with our progress to date, we dare not rest content. The unfinished business of economic policy includes (1) the achievement of full employment and sustained prosperity without inflation, (2) the acceleration of economic growth, (3) the extension of equality of opportunity, and (4) the restoration of balance of pay-
ments equilibrium. Economic policy thus confronts a demanding assignment, but one which can and will be met within the framework of a free economy.

Our Goal of Full and Sustained Prosperity Without Inflation

Recovery has carried the economy only part of the way to the goal of "maximum production, employment, and purchasing power." The standing challenge of the Employment Act is not merely to do better, but to do our best—the "maximum." Attainment of that maximum in 1963 would mean a GNP of approximately $600 billion, wages and salaries of over $320 billion, and corporate profits of as much as $60 billion, all in 1961 prices. The material gains are themselves staggering, but they are less important than the new sense of purpose and the new opportunities for improvement of American life that could be realized by "maximum" use of the productive capacity now lying idle and the capacity yet to be created.

Involuntary unemployment is the most dramatic sign and disheartening consequence of underutilization of productive capacity. It translates into human terms what may otherwise seem merely an abstract statistic. We cannot afford to settle for any prescribed level of unemployment. But for working purposes we view a 4 percent unemployment rate as a temporary target. It can be achieved in 1963, if appropriate fiscal, monetary, and other policies are used. The achievable rate can be lowered still further by effective policies to help the labor force acquire the skills and mobility appropriate to a changing economy. We must also continue the cooperative effort, begun with the Area Redevelopment Act of 1961, to bring industry to depressed areas and jobs to displaced workers. Ultimately, we must reduce unemployment to the minimum compatible with the functioning of a free economy.

We must seek full recovery without endangering the price stability of the last 4 years. The experience of the past year has shown that expansion without inflation is possible. With cooperation from labor and management, I am confident that we can go on to write a record of full employment without inflation.

The task of economic stabilization does not end with the achievement of full recovery. There remains the problem of keeping the economy from straying too far above or below the path of steady high employment. One way lies inflation, and the other way lies recession. Flexible and vigilant fiscal and monetary policies will allow us to hold the narrow middle course.
Our Goal of Economic Growth

While we move toward full and sustained use of today's productive capacity, we must expand our potential for tomorrow. Our postwar economic growth—though a step ahead of our record for the last half-century—has been slowing down. We have not in recent years maintained the 4 to 4⅓ percent growth rate which characterized the early postwar period. We should not settle for less than the achievement of a long-term growth rate matching the early postwar record. Increasing our growth rate to 4⅓ percent a year lies within the range of our capabilities during the 1960's. It will lay the groundwork for meeting both our domestic needs and our world responsibilities.

In November of last year we joined with our 19 fellow members of the Organization for Economic Cooperation and Development in setting a common target for economic growth. Together we pledged ourselves to adopt national and international policies aimed at increasing the combined output of the Atlantic Community by 50 percent between 1960 and 1970. The nations of the West are encouraged and enlivened by America's determination to make its full contribution to this joint effort.

We can do our share. In the mid-1960's, the children born in 1943 and after will be arriving at working age. The resulting rapid growth in our labor force offers us an opportunity, not a burden—provided that we deliver not only the jobs but also the research, the training, and the capital investment to endow our new workers with high and rising productivity as they enter economic life.

Our Goal of Equal Opportunity

Increasingly in our lifetime, American prosperity has been widely shared and it must continue so. The spread of primary, secondary, and higher education, the wider availability of medical services, and the improved postwar performance of our economy have bettered the economic status of the poorest families and individuals.

But prosperity has not wiped out poverty. In 1960, 7 million families and individuals had personal incomes lower than $2,000. In part, our failure to overcome poverty is a consequence of our failure to operate the economy at potential. The incidence of unemployment is always uneven, and increases in unemployment tend to inflict the greatest income loss on those least able to afford it. But there is a claim on our conscience from others, whose poverty is barely touched by cyclical improvements in general economic activity. To an increasing extent,
the poorest families in America are those headed by women, the elderly, nonwhites, migratory workers, and the physically or mentally handicapped—people who are shortchanged even in time of prosperity.

Last year's increase in the minimum wage is evidence of our concern for the welfare of our low-income fellow citizens. Other legislative proposals now pending will be particularly effective in improving the lot of the least fortunate. These include (1) health insurance for the aged, financed through the social security system, (2) Federal aid for training and retraining our unemployed and underemployed workers, (3) the permanent strengthening of our unemployment compensation system, and (4) substantial revision in our public welfare and assistance program, stressing rehabilitation services which help to restore families to independence.

Public education has been the great bulwark of equality of opportunity in our democracy for more than a century. Our schools have been a major means of preventing early handicaps from hardening into permanent ignorance and poverty. There can be no better investment in equity and democracy—and no better instrument for economic growth. For this reason, I urge action by the Congress to provide Federal aid for more adequate public school facilities, higher teachers' salaries, and better quality in education. I urge early completion of congressional action on the bill to authorize loans for construction of college academic facilities and to provide scholarships for able students who need help. The talent of our youth is a resource which must not be wasted.

Finally, I shall soon propose to the Congress an intensive program to reduce adult illiteracy, a handicap which too many of our fellow citizens suffer because of inadequate educational opportunities in the past.

Our Goal of Basic Balance in International Payments

Persistent international payments deficits and gold outflows have made the balance of payments a critical problem of economic policy. We must attain a balance in our international transactions which permits us to meet heavy obligations abroad for the security and development of the free world, without continued depletion of our gold reserves or excessive accumulation of short-term dollar liabilities to foreigners. Simultaneously, we must continue to reduce barriers to international trade and to increase the flow of resources from developed to developing countries. To increase our exports is a task of highest priority, and one which gives heightened significance to the maintenance of price stability and the rapid increase of productivity at home.
Prospects for 1962

The Nation will make further economic progress in 1962. Broad advances are in prospect for the private economy. The gains already achieved have set the stage for further new records in output, employment, personal income, and profits. Rising household incomes brighten the outlook for further increases in consumer buying, particularly of durable goods. Business firms will need larger inventories to support higher sales, and improved profits and expanded markets will lead to rising capital outlays. The outlays of Federal, State, and local governments will continue to increase as we work for peace and progress.

In the first half of 1962, we may therefore expect vigorous expansion in production and incomes, with GNP increasing to a range of $565–570 billion in the second quarter, employment continuing to rise, and the unemployment rate falling further.

In the second half of 1962, business investment in plant and equipment should pick up speed and help maintain the momentum of progress toward full employment—and toward future economic growth. Rising output should push factory operating rates closer to capacity and raise profits still further above previous records. To these incentives for capital expenditures will be added Treasury liberalization of depreciation guidelines and, if the Congress acts favorably, the 8 percent tax credit for machinery and equipment outlays.

For 1962 as a whole, GNP is expected to rise approximately $50 billion above the $521 billion level of 1961. This would be another giant stride toward a fully employed economy. The record of past recoveries and of the U.S. economy's enormous and growing potential indicates that this is a gain we can achieve. In the perspective of our commitments both to our own expanding population and to the world, it is a gain we need to achieve.

Budgetary Policy

Prosperity shrinks budgetary deficits, as recessions create them. Budget revenues are expected to rise 13 percent between the fiscal years 1962 and 1963; revenues rose 14½ percent between 1959 and 1960 in the previous upswing. Such sensitivity of budget revenues to business activity is desirable because it moderates swings in private purchasing power.

I have submitted to the Congress a Budget which will balance in fiscal 1963 as prosperity generates sharply rising tax revenues. The Budget
is appropriately paced to the expected rate of economic expansion. It will give less stimulus to business activity as private demand for goods and services grows stronger and shoulders more of the responsibility for continued gains. But the shift will be moderate and gradual. We have learned from the disappointing 1959–60 experience that an abrupt and excessively large swing in the Budget can drain the vigor from the private economy and halt its progress, especially if a restrictive monetary policy is followed simultaneously. This will not be repeated. Budget outlays will rise by $3\frac{1}{2}$ billion from fiscal 1962 to fiscal 1963, whereas they fell by more than that amount from fiscal 1959 to fiscal 1960. The 1963 Budget starts from a much smaller deficit and will move to a moderate surplus as the recovery strengthens.

With support from increased government expenditures and other government policies, the momentum of the recovery is expected to raise GNP to $570 billion for 1962 as a whole. Prompt enactment of the proposed tax credit for investment would give the economy further strength. Economic expansion at the expected pace will yield $93.0 billion in Budget revenues in fiscal 1963 to cover $92.5 billion in Budget expenditures. If private demands for goods and services should prove to be weaker in 1962 than now anticipated, less private purchasing power will flow into taxes, and Budget revenues will fall short of the $93.0 billion figure. If private demands are stronger, tax receipts will rise further and Budget revenues will exceed expectations.

A surplus of $4.4 billion in fiscal 1963 is expected in the national income accounts budget—a budget constructed to measure the direct impact of Federal expenditures and receipts on the flow of total spending. The surplus would be several billion dollars higher if the economy were operating steadily at a level high enough to hold unemployment to 4 percent.

Either surplus—prospective or potential—is both a challenge and an opportunity. A government surplus is a form of saving—an excess of income over expenditure. Like any other form of saving, it releases labor and other productive resources which can be used to create new investment goods—plant, equipment, or houses. If investment demand is not strong enough to use the resources and labor, they will be wasted in unemployment and idle capacity, and the surplus itself will not be realized. But if the necessary investment demand is present, the surplus will make possible the acceleration of economic growth by enlarging the future productive power of the economy. The Government is seeking to help American industry to meet this challenge and seize this opportunity, through such measures as the 8 percent investment tax credit and revisions of depreciation guidelines.
We face 1962 with optimism but not complacency. If private demand shows unexpected strength, public policy must and will act to avert the dangers of rising prices. If demand falls short of current expectations, more expansionary policies will be pursued. In 1962, vigilance and flexibility must be the guardians of economic optimism.

**Monetary and Credit Policies**

Monetary, credit, and debt management policies can also help to assure that productive outlets exist for the funds that the American people save from prosperity incomes. The balance foreseen in the Budget for fiscal year 1963, and the surplus which would arise at full employment, both indicate that fiscal policy is assuming a large share of the burden of forestalling inflationary excesses of demand. With monetary and related policies relieved of a substantial part of this burden, they can more effectively be used to assure a flow of investment funds which will transform the economy's present capacity to save into future capacity to produce.

At the same time, monetary and debt management policies must continue to protect the balance of international payments against outflows of short-term capital. As in 1961, domestic expansion and the balance of payments confront these policies with a dual task, requiring continued ingenuity in technique and flexibility in emphasis.

**Balance of Payments**

The program launched last year to reduce our payments deficit and maintain confidence in the dollar will, I am sure, show further results in 1962. I am hopeful that the target of reasonable equilibrium in our international payments can be achieved within the next two years; but this will require a determined effort on the part of all of us—government, business and labor. This effort must proceed on a number of fronts.

*Export expansion.* An increase in the U.S. trade surplus is of the first importance. If we are to meet our international responsibilities, we must increase exports more rapidly than the increase in imports which accompanies our economic growth.

Our efforts to raise exports urgently require that we negotiate a reduction in the tariff of the European Common Market. I shall shortly transmit to the Congress a special message elaborating the details of the proposed Trade Expansion Act of 1962 and explaining why I believe that a new trade policy initiative is imperative this year.
To encourage American businessmen to become more export-minded, we have inaugurated a new export insurance program under the leadership of the Export-Import Bank, and we have stepped up our export promotion drive by improving the commercial services abroad of the U.S. Government, establishing trade centers abroad, planning trade fairs, improving the trade mission program, and working with business firms on export opportunities through field offices of the Department of Commerce and the Small Business Administration. Foreign travel to the United States, which returns dollars to our shores, is now being promoted through the first Federal agency ever created for this purpose.

**Prices and productivity.** Our export drive will founder if we cannot keep our prices competitive in world markets. Though our recent price performance has been excellent, the improving economic climate of 1962 will test anew the statesmanship of our business and labor leaders. I believe that they will pass the test; our Nation today possesses a new understanding of the vital link between our level of prices and our balance of payments.

In the long run, the competitive position of U.S. industry depends on a sustained and rapid advance in productivity. In this, the interests of economic recovery, long-run growth, and the strength of the dollar coincide. Modernization and expansion of our industrial plant will accelerate the advance of productivity.

**Foreign investment.** To place controls over the flow of private American capital abroad would be contrary to our traditions and our economic interests. But neither is there justification for special tax incentives which stimulate the flow of U.S. investment to countries now strong and economically developed, and I again urge the elimination of these special incentives.

The new foreign trade program which I am proposing to the Congress will help to reduce another artificial incentive to U.S. firms to invest abroad. The European Common Market has attracted American capital, partly because American businessmen fear that they will be unable to compete in the growing European market unless they build plants behind the common tariff wall. We must negotiate down the barriers to trade between the two great continental markets, so that the exports of our industry and agriculture can have full opportunity to compete in Europe.

**Governmental expenditures abroad.** Military expenditures form by far the greater part of our governmental outlays abroad. We are discussing with certain of our European allies the extent to which they can increase their own military procurement from the United States to offset our dollar expenditures there. As a result, the net cost to our
balance of payments is expected to be reduced during the coming year, in spite of increased deployment of forces abroad because of the Berlin situation.

To curtail our foreign aid programs in order to strengthen our balance of payments would be to sacrifice more than we gain. But we can cut back on the foreign currency costs of our aid programs, and thus reduce the burden on our balance of payments. A large percentage of our foreign aid is already spent for procurement in the United States; this proportion will rise as our tightened procurement procedures become increasingly effective.

We have sought to induce other advanced countries to undertake a larger share of the foreign aid effort. We will continue our efforts through the Development Assistance Committee of the Organization for Economic Cooperation and Development to obtain a higher level of economic assistance by other industrial nations to the less developed countries.

Short-term capital movements. Outflows of volatile short-term funds added to the pressures on the dollar in 1960. Our policies in 1961 have diminished the dangers of disruptive movements of short-term capital. For the first time in a generation, the Treasury is helping to stabilize the dollar by operations in the international exchange markets. The Federal Reserve and the Treasury, in administering their monetary policy and debt management responsibilities, have sought to meet the needs of domestic recovery in ways which would not lead to outflows of short-term capital.

During the past year, we have consulted periodically with our principal financial partners, both bilaterally and within the framework of the OECD. These consultations have led to close cooperation among fiscal and monetary authorities in a common effort to prevent disruptive currency movements.

Strengthening the international monetary system. The International Monetary Fund is playing an increasingly important role in preserving international monetary stability. The reserve strength behind the dollar includes our drawing rights on the Fund, of which $1.7 billion is automatically available under current practices of the Fund. An additional $4.1 billion could become available under Fund policies, insofar as the Fund has available resources in gold and usable foreign currencies. Recently, the Fund has diversified its use of currencies in meeting drawings by member countries, relying less heavily on dollars and more heavily on the currencies of countries with payments surpluses. However, the Fund's regular holdings of the currencies of some important
industrial countries are not adequate to meet potential demands for them.

In a message to the Congress last February, I said: “We must now, in cooperation with other lending countries, begin to consider ways in which international monetary institutions—especially the International Monetary Fund—can be strengthened and more effectively utilized, both in furnishing needed increases in reserves, and in providing the flexibility required to support a healthy and growing world economy.”

We have now taken an important step in this direction. Agreement has been reached among ten of the major industrial countries to lend to the Fund specified amounts of their currencies when necessary to cope with or forestall pressures which may impair the international monetary system. These stand-by facilities of $6 billion will be a major defense against international monetary speculation and will powerfully reinforce the effectiveness of the Fund. They will provide resources to make our drawing rights in the Fund effective, should we need to use them. Moreover, the U.S. stand-by commitment of $2 billion will augment the resources potentially available through the Fund to other participants in the agreement, when our balance of payments and reserve positions are strong. I shall shortly submit a request to Congress for appropriate enabling legislation.

Prices and Wages

Prices and production need not travel together. A number of foreign countries have experienced both rapid growth and stable prices in recent years. We ourselves, in 1961, enjoyed a stable price level during a brisk economic recovery.

While rising prices will not necessarily accompany the expansion we expect in 1962, neither can we rely on chance to keep our price level stable. Creeping inflation in the years 1955–57 weakened our international competitive position. We cannot afford to allow a repetition of that experience.

We do not foresee in 1962 a level of demand for goods and services which will strain the economy’s capacity to produce. Neither is it likely that many industries will find themselves pressing against their capacity ceilings. Inflationary pressures from these sources should not be a problem.

But in those sectors where both companies and unions possess substantial market power, the interplay of price and wage decisions could set off a movement toward a higher price level. If this were to occur, the whole Nation would be the victim.
I do not believe that American business or labor will allow this to happen. All of us have learned a great deal from the economic events of the past 15 years. Among both businessmen and workers, there is growing recognition that the road to higher real profits and higher real wages is the road of increased productivity. When better plant and equipment enable the labor force to produce more in the same number of hours, there is more to share among all the contributors to the productive process—and this can happen with no increase in prices. Gains achieved in this manner endure, while gains achieved in one turn of the price-wage spiral vanish on the next.

The Nation must rely on the good sense and public spirit of our business and labor leaders to hold the line on the price level in 1962. If labor leaders in our major industries will accept the productivity benchmark as a guide to wage objectives, and if management in these industries will practice equivalent restraint in their price decisions, the year ahead will be a brilliant chapter in the record of the responsible exercise of freedom.

**Measures for a Stronger Economy**

The final section of my Report is a summary of my recommendations for legislative action (1) to strengthen our defenses against recession, (2) to strengthen our financial system, (3) to strengthen our manpower base, and (4) to strengthen our tax system.

**A Program for Sustained Prosperity**

Recurrent recessions have thrown the postwar American economy off stride at a time when the economies of other major industrial countries have moved steadily ahead. To improve our future performance I urge the Congress to join with me in erecting a defense-in-depth against future recessions. The basic elements of this defense are (1) Presidential stand-by authority for prompt, temporary income tax reductions, (2) Presidential stand-by authority for capital improvements expenditures, and (3) a permanent strengthening of the unemployment compensation system. These three measures parallel important proposals of the Commission on Money and Credit, whose further recommendations are treated under the next heading.

In our free enterprise economy, fluctuations in business and consumer spending will, of course, always occur. But this need not doom us to an alternation of lean years and fat. The business cycle does not have the inevitability of the calendar. The Government can time its fiscal transactions to offset and to dampen fluctuations in the private economy.
Our fiscal system and budget policy already contribute to economic stability, to a much greater degree than before the war. But the time is ripe, and the need apparent, to equip the Government to act more promptly, more flexibly, and more forcefully to stabilize the economy—to carry out more effectively its charge under the Employment Act.

Stand-by tax reduction authority. First, I recommend the enactment of stand-by authority under which the President, subject to veto by the Congress, could make prompt temporary reductions in the rates of the individual income tax to combat recessions, as follows:

(1) Before proposing a temporary tax reduction, the President must make a finding that such action is required to meet the objectives of the Employment Act.

(2) Upon such finding, the President would submit to Congress a proposed temporary uniform reduction in all individual income tax rates. The proposed temporary rates may not be more than 5 percentage points lower than the rates permanently established by the Congress.

(3) This change would take effect 30 days after submission, unless rejected by a joint resolution of the Congress.

(4) It would remain in effect for 6 months, subject to revision or renewal by the same process or extension by a joint resolution of the Congress.

(5) If the Congress were not in session, a Presidentially proposed tax adjustment would automatically take effect but would terminate 30 days after the Congress reconvened. Extension would require a new proposal by the President, which would be subject to congressional veto.

A temporary reduction of individual income tax rates across the board can be a powerful safeguard against recession. It would reduce the annual rate of tax collections by $2 billion per percentage point, or a maximum of $10 billion—$1 billion per point, or a $5-billion maximum, for six months—at present levels of income. These figures should be measured against the costs they are designed to forestall:

—the tens of billions of potential output that run to waste in recession;

—the pain and frustration of the millions whom recessions throw out of work;

—the Budget deficits of $12.4 billion in fiscal 1959 or $7.0 billion this year.

The proposed partial tax suspension would launch a prompt counterattack on the cumulative forces of recession. It would be reflected
immediately in lower withholding deductions and higher take-home pay for millions of Americans. Markets for consumer goods and services would promptly feel the stimulative influence of the tax suspension.

It would offer strong support to the economy for a timely interval, while preserving the revenue-raising powers of our tax system in prosperity and the wise traditional procedures of the Congress for making permanent revisions and reforms in the system. I am not asking the Congress to delegate its power to levy taxes, but to authorize a temporary and emergency suspension of taxes by the President—subject to the checkrein of Congressional veto—in situations where time is of the essence.

**Stand-by capital improvements authority.** Second, I recommend that the Congress provide stand-by authority to the President to accelerate and initiate up to $2 billion of appropriately timed capital improvements when unemployment is rising, as follows:

1. The President would be authorized to initiate the program within two months after the seasonally adjusted unemployment rate
   - had risen in at least three out of four months (or in four out of six months) and
   - had risen to a level at least one percentage point higher than its level four months (or six months) earlier.

2. Before invoking this authority, the President must make a finding that current and prospective economic developments require such action to achieve the objectives of the Employment Act.

3. Upon such finding, the President would be authorized to commit
   - up to $750 million in the acceleration of direct Federal expenditures previously authorized by the Congress,
   - up to $750 million for grants-in-aid to State and local governments,
   - up to $250 million in loans to States and localities which would otherwise be unable to meet their share of project costs, and
   - up to $250 million additional to be distributed among the above three categories as he might deem appropriate.

4. The authority to initiate new projects under the capital improvements program would terminate automatically within 12 months unless extended by the Congress—but the program could be terminated at any time by the President.
(5) Grants-in-aid would be made under rules prescribed by the President to assure that assisted projects (a) were of high priority, (b) represented a net addition to existing State and local expenditures, and (c) could be started and completed quickly.

(6) Expenditures on Federal projects previously authorized by the Congress would include resource conservation and various Federal public works, including construction, repair, and modernization of public buildings.

(7) After the program had terminated, the authority would not again be available to the President for six months.

The above criteria would have permitted Presidential authority to be invoked in the early stages of each of the four postwar recessions—within four months after the decline had begun. Furthermore, no false signals would have been given. Were a false signal to occur—for example, because of a strike—the authority, which is discretionary, need not be invoked.

The first impact of the accelerated orders, contracts, and outlays under the program would be felt within one to two months after the authority was invoked. The major force of the program would be spent well before private demand again pressed hard on the economy's capacity to produce. With the indicated safeguards, this program would make a major contribution to business activity, consumer purchasing power, and employment in a recession by utilizing for sound public investment resources that would otherwise have gone to waste.

Unemployment compensation. Third, I again urge the Congress to strengthen permanently our Federal-State system of unemployment insurance. My specific recommendations include

(1) Extension of the benefit period by as much as 13 weeks for workers with at least three years of experience in covered employment;

(2) Similar extension of the benefit period when unemployment is widespread for workers with less than three years of experience in covered employment. This provision could be put into effect by Presidential proclamation when insured unemployment reaches 5 percent, and the number of benefit exhaustions over a three-month period reaches 1 percent of covered employment;

(3) Incentives for the States to provide increased benefits, so that the great majority of covered workers will be eligible for weekly benefits equal to at least half of their average weekly wage;

(4) Extension of coverage to more than three million additional workers;
(5) Improved financing of the program by an increase in the wage base for the payroll tax from $3,000 to $4,800;
(6) Reinsurance grants to States experiencing high unemployment insurance costs;
(7) Provisions which permit claimants to attend approved training or retraining courses without adverse effect on eligibility for benefits.

Wider coverage, extended benefit periods, and increased benefit amounts will help society discharge its obligation to individual unemployed workers. And by maintaining more adequately their incomes and purchasing power, these measures will also buttress the economy's built-in defenses against recession. Temporary extensions of unemployment compensation benefits have been voted by the Congress during the last two recessions. It is time now for permanent legislation to bring this well-tested stabilizer more smoothly into operation when economic activity declines.

In combination, these three measures will enable Federal fiscal policy to respond firmly, flexibly, and swiftly to oncoming recessions. Working together on this bold program, the Congress and the Executive can make an unprecedented contribution to economic stability, one that will richly reward us in fuller employment and more sustained growth, and thus, in greater human well-being and greater national strength.

Strengthening the Financial System

Proposals of the Commission on Money and Credit. The Report of the Commission on Money and Credit, published last year, raises important issues of public policy relating to (1) the objectives and machinery of Government for economic stabilization and growth, (2) Federal direct lending and credit guarantee programs, and (3) the structure and regulation of private financial institutions and markets. The Commission's Report represents the results of thorough analysis and deliberation by a private group of leading citizens representative of business, labor, finance, agriculture, and the professions. The Commission's findings and recommendations deserve careful consideration by the Congress, the Executive, and the public—consideration which should result in legislative and executive actions to strengthen government policy under the Employment Act and to improve the financial system of the United States. The subjects covered by the Commission can—for the purposes of discussion and action in the Government—usefully be divided into four categories.
(1) To strengthen the instruments of policy for economic stabilization, the Commission recommends permanent improvement of unemployment compensation, flexibility in government capital expenditures, and flexibility in adjusting the basic Federal individual income tax rate. These key proposals are reflected in the three-part antirecession program just described.

(2) In its comprehensive new look at existing financial legislation, the Commission concludes that the following financial restrictions no longer serve the purposes originally intended and unnecessarily complicate or obstruct other government policies: the ceiling on the public debt, the ceiling on permissible interest rates on U.S. Treasury bonds, and the required gold reserve against Federal Reserve notes and deposits. I am sure that the Congress will wish to examine carefully the Commission's recommendations on these points.

(3) The Commission re-examines the structure of the Federal Reserve System and its relationship to other arms of the Federal Government. The desirability of proposed changes in the structure which has evolved over the years can be determined only after extensive consideration by the Congress and by the public.

There are two reforms of clear merit on which there appears to be sufficiently general agreement to proceed at once, and which are of direct concern to the President in the exercise of his responsibility to appoint the members and officers of the Board of Governors of the Federal Reserve System.

The first is to give adequate recognition in the simple matter of salaries to the important responsibilities of the Board of Governors of the Federal Reserve System. The United States is behind other countries in the status accorded, by this concrete symbol, to the leadership of its "central bank," and I urge that the Congress take corrective action.

The second is to revise the terms of the officers and members of the Board so that a new President will be able to nominate a Chairman of his choice for a term of four years coterminous with his own. This change has the concurrence of the present Chairman of the Board of Governors. The current situation—under which the four-year term of the Chairman is not synchronized with the Presidential term—appears to be accidental and inadvertent.

Provision should be made now for smooth transition to new arrangements to take effect in 1965. I suggest that, on the expiration of the present term of the Chairman in April 1963, the next term expire on January 31, 1965. In order that, starting in 1965, the President may have a free choice when he begins his own term, it is also
necessary to provide that the terms of members of the Board—which now begin and end on January 31 of even years—begin and end in odd years. This change can be accomplished very easily by extending the terms of present members by one year.

(4) Several of the Commission’s recommendations require careful appraisal by the affected agencies in the Executive Branch as a basis for future legislative recommendations:

(a) Banks and other private financial institutions: The Commission proposes significant changes in the scope and nature of government regulations concerning reserves, portfolios, interest rates, and competition. I shall ask an interagency working group in the Executive Branch to examine the complex issues raised by these proposals. This interagency group will keep in close touch with the relevant committees of the Congress, which will no doubt wish to study these issues simultaneously.

(b) Federal lending and loan guarantee programs: It is clearly time for a thorough review of both their general impact on the economy and their effectiveness for the special purposes for which they were established. Again the Commission’s Report has performed a valuable service in illuminating basic problems. One important question is the appropriate role—with account taken of both effectiveness and budgetary cost—of direct Federal lending, loan guarantees, and interest sharing. I shall ask a second interagency group in the Executive Branch to examine these programs.

(c) Corporate pension funds and other private retirement programs: It is time for a reappraisal of legislation governing these programs. They have become, in recent years, a major custodian of individual savings and an important source of funds for capital markets. The amendment to the Welfare and Pension Plans Disclosure Act which I recommend below will be an important step toward insuring fidelity in the administration of these Plans. But there is also need for a review of rules governing the investment policies of these funds and the effects on equity and efficiency of the tax privileges accorded them. I shall ask a third working group of relevant Departments and agencies to recommend needed actions in this field, taking into account the findings of the Commission as well as other studies and proposals.

A revision of silver policy. Silver—a sick metal in the 1930’s—is today an important raw material for which industrial demand is expanding steadily. It is uneconomic for the U.S. Government to lock up large quantities of useful silver in the sterile form of currency reserves.
Neither is any constructive purpose served by requiring that the Treasury maintain a floor under the price of silver. Silver should eventually be demonetized, except for its use in coins.

(1) As a first step in freeing silver from government control, the Secretary of the Treasury at my direction suspended sales of silver on November 29. This order amounted to the withdrawal of a price ceiling on silver which had been maintained by Treasury sales at a fixed price.

(2) The next step should be the withdrawal of the Treasury’s price floor under domestically produced silver. Accordingly, I recommend repeal of the Acts relating to silver of June 19, 1934, July 6, 1939, and July 31, 1946; this step will free the Treasury from any future obligation to support the price of silver.

(3) I also recommend the repeal of the special 50 percent tax on transfers of interest in silver; this step will foster orderly price movements by encouraging the development of a futures market in silver.

(4) Finally, I recommend that the Federal Reserve System be authorized to issue Federal Reserve notes in denominations of $1; this will make possible the gradual withdrawal from circulation of $1 and $2 silver certificates, and the use of the silver thus released for coinage purposes.

**Strengthening Our Manpower Base**

The labor force of the United States is its most valuable productive resource. Measures which enhance the skills and adaptability of the working population contribute to the over-all productivity of the economy. Several legislative proposals to serve these ends have already been put before the Congress.

(1) I urge speedy passage of the proposed Manpower Development and Training Act. A growing and changing economy demands a labor force whose skills adapt readily to the requirements of new technology. When adaptation is slow and occupational lines rigid, individuals and society alike are the losers. Individuals take their loss in the form of prolonged unemployment or sharply reduced earning power. Society’s loss is measured in foregone output. These are losses we need not suffer. A few hundred dollars invested in training or retraining an unemployed or underemployed worker can increase his productivity to society by a multiple of that investment—quite apart from the immeasurable return to the worker in regaining a sense of purpose and hope. Both compassion and dollars-and-cents reasoning speak for this legislation.
(2) For the same reasons, I urge enactment of the Youth Employment Opportunities Act. This bill provides three types of pilot programs to give young people employment opportunities which would enable them to acquire much-needed skills. These programs include training, employment in public service jobs with public and private nonprofit agencies, and the establishment of Youth Corps Conservation Camps. In the current decade, young men and women will be entering the labor force in rapidly growing numbers. They will expect, and they deserve, opportunities to acquire skills and to do useful work. The price of failure is frustration and disillusion among our youth. This price we are resolved not to pay.

(3) I have already made my recommendations for improvement of the Federal-State unemployment compensation system.

(4) I am asking the Congress for more funds to increase the effectiveness of the U.S. Employment Service. This important agency has already strengthened its operations, improving its staff and placement services particularly in the largest urban centers, and concentrating on labor market problems of nationwide significance—especially those connected with technological displacement of adult workers and the employment of youth. But the matching of jobs and workers is especially difficult and especially important in a rapidly changing economy, and more can be done. When unfilled jobs and qualified unemployed workers coexist—but do not make contact because the flow of job information is not sufficiently free—the employer, the worker, and the country lose. I urge the Congress to reduce that loss in the most effective way—by revitalizing further the agency charged with disseminating information about job opportunities and willing workers.

(5) I ask for enactment of the pending proposal to amend the Welfare and Pension Plans Disclosure Act so as (a) to provide adequate penalties for embezzlement and (b) to vest authority in a responsible Federal agency to enforce the statute by issuing binding regulations, prescribing uniform reporting forms, and investigating violations. Almost 90 million people rely on some welfare and pension plan for part or all of present or future income. These plans are a major support of the economic security of the American people. We are derelict if we do not provide adequate administrative and enforcement provisions to protect the tremendous financial interest of participants in these funds.

**Strengthening Our Tax System**

The tax system of the United States has consequences far beyond the simple raising of revenue. The tax laws are a vital part of the economic
environment; their effects may be equitable or inequitable; they create incentives which may help or handicap the national interest. We cannot safely ignore these important effects in the comforting illusion that what already exists is perfect. We must scrutinize our tax system carefully to insure that its provisions contribute to the broad goals of full employment, growth, and equity.

My legislative proposals in the tax field are directly related to these goals and the corollary need for improvement in the balance of payments. In particular, I urge the earliest possible enactment of the tax proposals now before the House Committee on Ways and Means. The centerpiece of these proposals is the 8 percent tax credit against tax for gross investment in depreciable machinery and equipment. The credit should be retroactive to January 1, 1962. The tax credit increases the profitability of productive investment by reducing the net cost of acquiring new equipment. It will stimulate investment in capacity expansion and modernization, contribute to the growth of our productivity and output, and increase the competitiveness of American exports in world markets.

The tax credit for investment is in part self-financing. The stimulus it provides to new investment will have favorable effects on the level of economic activity during the year, and this will in turn add to Federal revenues. My other proposals for tax reform are designed to improve the equity and efficiency of the tax system and will offset the remaining net revenue loss:

1. Extension of the withholding principle to dividend and interest income;
2. Repeal of the $50 dividend exclusion and the 4 percent dividend credit;
3. Revision of the tax treatment of business deductions for entertainment, gifts, and other expenses, to stop abuses of “expense-account living”;
4. Elimination of the special tax preference for capital gains from the sale of depreciable property, real and personal;
5. Removal of unwarranted preferences (a) to cooperatives, (b) to mutual fire and casualty insurance companies, and (c) to mutual savings banks and savings and loan associations; and
6. Revision of the tax treatment of foreign income, to remove defects and inequities in the law. Removal of the unwarranted incentive to the export of capital will be consistent with the efficient distribution of capital resources in the world
and will aid our balance of payments position. Tax deferral
privileges should be limited to profits earned in less developed
countries, and opportunities for "tax haven" operations should
be eliminated.

In addition, I recommend that the corporate income tax and certain
excise taxes again be extended at present levels for another year beyond
June 30, 1962, except that the structure of taxes and user charges in
the transportation field be altered as proposed in my Budget Message.

In considering tax revision in the United States, we must not limit
ourselves simply to Federal taxation. Our States, counties, and mu-
nicipalities collect nearly half as much tax revenue as the Federal
Government. There is great potential for equity or inequity, for incentive or disincentive, in their highly diverse tax systems. In addition,
the effectiveness of Federal tax policies can be enhanced by harmonious
coordination with State and local fiscal systems. There is wide latitude
for improvements in the coordination of tax systems and in operations
with intergovernmental implications. In this effort, the Advisory Com-
mission on Intergovernmental Relations is performing a valuable service.
I urge careful study of its recommendations at all levels of government.

Later this year, I shall present to the Congress a major program of
tax reform. This broad program will re-examine tax rates and the
definition of the income tax base. It will be aimed at the simplification
of our tax structure, the equal treatment of equally situated persons,
and the strengthening of incentives for individual effort and for
productive investment.

The momentum of our economy has been restored. This momen-
tum must be maintained, if the full potential of our free economy is
to be released in the service of the Nation and the world. In this
Report I have proposed a program to sustain our prosperity and accel-
erate our growth—in short, to realize our economic potential. In this
undertaking, I ask the support of the Congress and the American people.
THE ANNUAL REPORT
OF THE
COUNCIL OF ECONOMIC ADVISERS
LETTER OF TRANSMITTAL

COUNCIL OF ECONOMIC ADVISERS,

The President:

Respectfully,

WALTER W. HELLER,
Chairman.

Kermit Gordon

James Tobin
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INTRODUCTION

The Report of the Council of Economic Advisers is a document directed toward economic problems and national economic policy. It is written in keen awareness that the ultimate goals of the Nation are human goals, and that economics is merely instrumental to the making of a better life for all Americans. Involuntary unemployment is a sign of economic waste, but the fundamental evil of unemployment is that it is an affront to human dignity. Expenditures on better education and better health are investments in future capacity to produce; but even if they were not, they would be intrinsically desirable because ignorance and illness bar the way to happiness and security for many of our citizens. Social security and welfare benefits help to limit the depth of recessions, but their more important function is to protect human beings from hunger and despair. Statistical tables are to the economist what test tube and microscope are to the scientist—the tools of the trade; but for the one as for the other, the ultimate dedication is to the quality of human life.

The Employment Act of 1946 is a historic affirmation of the responsibility of the Federal Government "to promote maximum employment, production, and purchasing power." The Act commits the Federal Government to seek to create and to maintain an economic environment in which "there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work." These goals, as the Act recognizes, must be sought within the broad framework of U.S. political and economic institutions—free competitive enterprise and the Federal system of government. And they must be sought by means consistent with other national needs, obligations, and objectives.

The people of this Nation—aided by an immense and fertile land, by rich stores of minerals and other gifts of nature, and by technologies and tools which lighten the work of man and multiply its fruits—can produce vast quantities of the goods and services human beings want. The Employment Act's broad goal of maximum employment, production, and purchasing power implies, first of all, that the vast productive capacity of the Nation should be used and not permitted to lie idle or run to waste. And, second, it implies that this capacity itself should be raised to enable each new generation to advance to higher standards of well-being.

The first of these objectives—maximum use of our existing productive resources—is the topic of Chapter 1. One requirement is to maintain aggregate demand for goods and services at, but not above, levels sufficient to buy the goods and services the economy is capable of producing. Since inadequate demand has in recent years been a major cause of unemploy-
ment and excess capacity, expansion of demand has been and remains a principal task of government policy. But expansion of demand is not the whole answer. The functioning of markets for labor and for its products can be improved in ways which will bring into effective use a greater proportion of the Nation’s productive resources. Government policy can play a role here too. These two aspects of the current economic situation, and the relevance of current and proposed policies, are discussed in Chapter 1.

The second objective—to accelerate the growth of the productive powers of the United States—is the subject of Chapter 2. The United States has joined its partners in the Organization for Economic Cooperation and Development (OECD) in setting “as a collective target the attainment during the decade from 1960 to 1970 of a growth in real gross national product of 50 percent for the 20 Member countries taken together.” This growth in production in Europe and North America is intended to lead both to an increase in standards of living in the industrial countries and to “a significant increase in aid to less developed countries.”

The OECD declaration underscores the fact that free nations must pursue their economic objectives in concert. U.S. policy under the Employment Act must take full account of our international economic transactions. Chapter 3, therefore, examines the U.S. balance of payments and the external position of the dollar, particularly as they are related to domestic economic developments and policies.

The necessity of moving toward balance in U.S. international accounts has given price stability new and compelling importance as a requirement of economic policy for recovery and growth. An appropriate and responsive structure of relative prices is equally important, to bring resources into full and efficient use and to guide the growing productive capacity of the economy to serve the Nation’s changing needs. Competition and mobility of resources, by contributing to the efficiency and flexibility of the price structure, will at the same time weaken upward pressures on the price level which sometimes accompany and endanger high employment. Chapter 4 is a discussion of recent, current, and prospective developments and policies affecting the course of prices in the United States.

Full utilization of manpower and other productive resources, faster growth in capacity to produce, balance of payments equilibrium, and price stability—these are necessarily the tasks of U.S. economic policy today. Significant progress has been made toward achieving all of them in 1961. In many important respects they are complementary; especially in the long run, measures which advance one task advance the others. But in other respects they are difficult to reconcile; measures useful for one purpose may be harmful for another. As perhaps never before, the complexity and the importance of the tasks facing the U.S. economy in this decade challenge the wisdom and vision of Government and of all sectors of the private economy.
Chapter 1

Toward Full Recovery

PART I: OBJECTIVES, PROGRESS, AND PROSPECTS

THE U.S. ECONOMY made substantial advances in 1961 toward the goals of the Employment Act: “maximum employment, production, and purchasing power.” Total production rose to a record rate of $542 billion a year in the fourth quarter, $41 billion above the level at the beginning of the year. Unemployment, which had been close to 7 percent of the labor force ever since December 1960, fell sharply toward the end of 1961; the rate was 6.1 percent in December. The annual rate of income, after taxes, of the American people rose from $1,940 per capita in the first quarter to $2,032 per capita in the last quarter of 1961. These gains in disposable income were almost entirely real gains in purchasing power. Prices were virtually stable during the year; the consumer index rose only 0.6 percent between December 1960 and November 1961. As the year ended, the economy was advancing vigorously.

Government fiscal and monetary policies contributed strongly to the favorable economic developments of the past year. Although the downswing probably would have ended early in 1961 in any case, the impressive pace of the economic expansion must be attributed in large measure to government actions. A summary of the Administration’s program in 1961 to promote economic recovery is given in the Appendix to this chapter.

In spite of the significant gains of 1961, the economy at the turn of the year still fell short of the standards set forth in the Employment Act. Too many persons “able, willing, and seeking to work” were unable to find “useful employment opportunities.” Even at record levels, national production had not yet reached its potential at full employment; and the purchasing power of the American people—the command over goods and services represented by their incomes—was still too low.

The prospect for 1962 is a continuation of the favorable trend of 1961. Whether the current expansion is sufficiently strong and durable to carry the economy to “maximum employment, production, and purchasing power”, no one can now foretell with certainty. Current and proposed government actions will continue to give strong support to economic expansion. If these are coupled with continued strength in the private economy, the current expansion would reduce unemployment to 4 percent of the labor force by mid-1963. But, given the inevitable uncertainties, government policy must be alert and flexible, ready to promote the achieve-
ment of full recovery within the coming fiscal year and to counteract developments which might threaten its attainment. The President has made important proposals to increase the effectiveness and flexibility of government fiscal policy; these are discussed at length in Part II of this chapter.

Part I of this chapter discusses, first, the current implications of the objectives of the Employment Act: "maximum employment" as a guide to the fiscal and monetary policies of Government and to other public and private policies of equal ultimate importance; and the potential production and purchasing power of the American economy at levels of employment which full recovery can achieve. Next, it describes the progress of the economy in 1961 toward these objectives and the outlook for continued advance in 1962. Part II of the chapter discusses government policies for full recovery and maximum employment, with special emphasis on the Administration's policies in 1961 and its programs under way or proposed for the coming year.

THE OBJECTIVE OF MAXIMUM EMPLOYMENT

Reasons for Concern over Unemployment

The great depression led this Nation, and most other nations of the free world, to assume national responsibility for the human tragedy and economic waste of involuntary unemployment. Unemployment had previously been regarded as almost solely the personal responsibility of the individual; now it came to be acknowledged as a charge on the conscience of the Nation. The mass unemployment of the 1930's led to new understanding: that to be unemployed is not to be unemployable; that job opportunities for individual workers depend on national economic circumstances beyond their control.

There are three principal reasons why involuntary unemployment is a national concern: (1) the human obligation to prevent and to relieve economic distress, (2) the basic principle of a free economy that an individual should be able to choose freely how to use his time, whether to work for pay or not, and (3) the economic waste of leaving productive resources idle.

Preventing economic distress. First, a wealthy nation cannot in good conscience permit its citizens to be inadequately nourished, clothed, or housed; its sick to be denied medical care; or its young to be deprived of schooling. Unemployment insurance and public assistance are recognitions of this social obligation. But they are not substitutes for the opportunity to earn income from useful employment. For the breadwinner and his family, unemployment means a reduction in living standards. Only about three-fifths of the unemployed in 1961 were receiving unemployment insurance benefits. Even those who were insured generally found weekly benefits a pale shadow of their lost wages. When the unemployment insurance program was inaugurated in the late 1930's, the goal was to provide benefits equal to about half of previous earnings. As Table 1 indicates,
benefits now do not meet this standard. The Administration has proposed permanent legislation to strengthen the unemployment insurance system in this and other respects.

**Table 1.—Weekly earnings in selected industries, and unemployment insurance benefits, 1961**

<table>
<thead>
<tr>
<th>Item</th>
<th>Weekly average, 1961</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unemployment insurance benefits, all industries</td>
<td>$33.80</td>
</tr>
<tr>
<td><strong>Weekly earnings, selected industries:</strong></td>
<td></td>
</tr>
<tr>
<td>Retail trade</td>
<td>64.61</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>92.34</td>
</tr>
<tr>
<td>Telephone communication</td>
<td>92.75</td>
</tr>
<tr>
<td>Wholesale trade</td>
<td>93.32</td>
</tr>
<tr>
<td>Bituminous coal mining</td>
<td>112.10</td>
</tr>
<tr>
<td>Class I railroads</td>
<td>112.41</td>
</tr>
<tr>
<td>Contract construction</td>
<td>117.66</td>
</tr>
</tbody>
</table>

1 For State programs only; see Table B-23.

2 Gross earnings for production workers or nonsupervisory employees; see Table B-27.

Source: Department of Labor.

For all too many, unemployment has not been simply an uncomfortable interlude between jobs but a catastrophe of long duration; almost one-third of those unemployed in December 1961 had been out of work for 15 or more weeks and one-sixth had been unemployed for at least 27 weeks. Family savings vanish when unemployment is prolonged.

Unemployment is not a perfect measure of the incidence of economic distress. Failure to find work does not entail poverty for some unemployed persons: women whose husbands have good jobs, young people who can fall back on well-to-do parents, older people who have assured livelihoods from property incomes or annuities, people who earn an adequate annual income from work at a seasonal occupation during part of a year. On the other hand, there are many causes of economic distress other than unemployment. Some persons, though employed, suffer from reduced and inadequate incomes resulting from failure to obtain more than part-time or occasional work, or to earn decent returns from long hours of self-employment on the farm or in the shop. Other individuals are not regarded as unemployed simply because, discouraged by a lack of suitable opportunities, they have abandoned the search for jobs. Included in this group are individuals with personal disabilities who can find jobs only when labor markets are tight.

Nevertheless, changes in unemployment are indicative of changes in the over-all magnitude of economic distress. The same conditions of general prosperity which lead to lower unemployment figures also lead to lower rates of involuntary part-time idleness, to better rewards from self-employment, and to more job opportunities for persons on the fringes of the labor force. While effective measures to provide adequate job opportunities will not solve all problems of economic distress, they will solve a substantial share of them. And without successful policy against general
unemployment, other attacks on poverty and insecurity stand little chance of success.

Assuring free choice. The second reason for national concern over unemployment is the basic principle of a free economy, embodied in the Employment Act, that "useful employment opportunities" be afforded "for those able, willing, and seeking to work." A free society abhors forced idleness as well as forced labor. This principle does not apply a means or needs test for job-seekers. It acknowledges that mature individuals should be able to choose for themselves how they spend their time, as between gainful employment, housework, leisure, and education. Involuntary unemployment can destroy morale and freedom of choice whether or not the individual is in economic need. Americans want to work. Neither welfare programs nor personal means can erase the frustration of the individual who is forced to conclude that society does not need or want his contribution. The general preference for gainful work over unemployment, however well compensated, is demonstrated by the low levels of unemployment in areas with buoyant labor markets, in occupations with ample job opportunities, and in the population at large during years of prosperity.

Avoiding economic waste. Finally, excessive unemployment is a waste of productive resources. When these resources are left idle, the useful goods and services they could have produced are forever lost to the Nation. These losses would be enormously wasteful at any time. They are dangerous in a decade when the economy must not only meet compelling domestic needs but underwrite the defense of freedom throughout the world. In coupling maximum production and purchasing power with maximum employment, the Employment Act recognizes the losses of national output and real income associated with unemployment. An estimate of these losses in present circumstances is attempted below. Changes in the unemployment rate are roughly indicative of changes in the "gap" between realized and potential production. The same measures of policy which will lower unemployment will also raise national output closer to capacity to produce. The national economic losses associated with unemployment are, of course, quite independent of the individual circumstances of the unemployed. If housewives, elderly persons, and teen-agers on vacation from school are eager and able to produce useful goods and services, it is foolish and wasteful for the Nation to forego their contributions.

Measures of unemployment. The global measure of unemployment as a percentage of the civilian labor force, provided monthly by the Current Population Survey and published by the Bureau of Labor Statistics, is the best single measure of the economic distress, the frustration of free choice, and the economic waste associated with unemployment. But there are other measures of independent interest. Four of these measures, along with the global rate, are shown in Chart 1:

1. The unemployment rate among experienced wage and salary workers—those who have already held at least one job. This measure
excludes the self-employed and new entrants to the labor force. (2) The unemployment rate among *married men living with their wives*. This measure relates to individuals whose commitment to the labor force is permanent and necessary to the support of their families. It does not cover all individuals with such a commitment, and conceptually it is inappropriate both as a measure of economic waste and as an indicator of involuntary unemployment among persons "able, willing, and seeking to work." (3) A *full-time equivalent* measure which (a) adds to the wholly unemployed the full-time equivalent of work lost by involuntary part-time employment and (b) subtracts the self-employed from both the labor force and civilian employment on the grounds that they are not subject to the risk of unemployment. This concept has merit as a measure of economic waste and of imbalance in markets for hired labor. (4) The number of

**CHART 1**

**Measures of Unemployment**

PERCENT UNEMPLOYED

<table>
<thead>
<tr>
<th>Year</th>
<th>Percent Unemployed</th>
</tr>
</thead>
<tbody>
<tr>
<td>1955</td>
<td>6.0</td>
</tr>
<tr>
<td>1956</td>
<td>7.5</td>
</tr>
<tr>
<td>1957</td>
<td>8.0</td>
</tr>
<tr>
<td>1958</td>
<td>10.0</td>
</tr>
<tr>
<td>1959</td>
<td>9.5</td>
</tr>
<tr>
<td>1960</td>
<td>8.0</td>
</tr>
<tr>
<td>1961</td>
<td>7.0</td>
</tr>
</tbody>
</table>

1/*UNEMPLOYED PLUS FULL-TIME EQUIVALENT OF PART-TIME EMPLOYED AS PERCENT OF CIVILIAN LABOR FORCE, EXCLUDES SELF-EMPLOYED AND UNPAID FAMILY WORKERS.*

2/*PERCENT OF CIVILIAN LABOR FORCE IN GROUP.*

3/*MARRIED MEN LIVING WITH THEIR WIVES.*

4/*PERSONS UNEMPLOYED 15 WEEKS OR MORE AS PERCENT OF CIVILIAN LABOR FORCE.*

SOURCES: DEPARTMENT OF LABOR AND COUNCIL OF ECONOMIC ADVISERS.
long-term unemployed, those who have been jobless for more than 15 weeks, as a percentage of the labor force. This rate is an important measure of the financial and social distress caused by the concentration of prolonged unemployment on a small fraction of the labor force.

The differences among these measures reveal more clearly than any single measure the anatomy of unemployment. But they show no systematic tendency to widen or narrow. If due allowance is made for volatility in month-to-month movements all five measures tell the same story about changes in economic conditions.

**Full Employment as the Objective of Stabilization Policy**

The goal of the Employment Act is “maximum employment,” or—to put it the other way round—minimum unemployment. Ideally, all persons able, willing, and seeking to work should be continuously employed. Involuntary unemployment is an individual and social evil. No one would prefer for its own sake a higher rate of unemployment to a lower one. But zero unemployment is unattainable. A more meaningful figure is needed to give content to the realistic and forceful declaration of policy in the Employment Act. A feasible interim goal must reflect a balancing of employment and production objectives with other considerations of national policy, within the limits set by the existing characteristics of the economy. Such a goal is set forth in the discussion which follows. We must not forget, however, that any practical unemployment goal is only a temporary compromise, and its attainment must never be an occasion for relaxation, but rather an incentive to search out ways to achieve a still lower rate.

The partial conflict which exists between minimum unemployment and certain other national objectives—and which imposes the necessity of striking a balance between them—results mainly from the fact that these other objectives are served by stability of the general price level. Given the existing structure of the economy and the nature of the processes by which prices and wages are determined, a serious attempt to push unemployment close to zero would produce a high rate of price inflation. The result would be a weakening of the competitive position of U.S. products in world markets, an arbitrary redistribution of real income and wealth, and a threat of even more serious consequences if expectations of further inflation should become dominant.

Happily, however, the conflict between the goals served by price stability and the goal of minimum unemployment is only partial. Stabilization policy—policy to influence the level of aggregate demand—can strike a balance between them which largely avoids the consequences of a failure in either direction. Furthermore, the degree of conflict can be diminished by private and public policies which improve the functioning of labor and product markets.

There are various possible causes of unemployment, on the one hand, and of inflationary pressure, on the other. These causes may be grouped
into (1) those related to aggregate demand and (2) those related to the structure and functioning of markets. It is necessary to distinguish carefully between these two groups of causes in setting an appropriate target for stabilization policy.

The relation of aggregate demand and of structural causes to unemployment may be briefly described as follows:

(1) The total effective demand for goods and services—by consumers, businesses, and governments—may be insufficient to employ all the persons seeking work at existing wage rates.

(2) Workers may be idle while vacancies are unfilled. This may arise because the workers live too far away from the available jobs, are not qualified for them, or simply are unaware of their existence. In a dynamic economy, there will always be workers between jobs, some seeking new positions out of preference, some displaced by economic and technological change. New entrants to the labor force will similarly be unemployed while locating jobs suitable to their qualifications and preferences. The length of "frictional" unemployment for any one worker, and the size of the pool of frictionally unemployed, depend on how smoothly the labor market functions, how well the skills, experience, and qualifications of workers match the specifications of available jobs, how ready workers are to change residence and occupation, how adequate are facilities for training and retraining, and how rapidly displacements resulting from economic change are occurring. Structural unemployment may be regarded as an extreme form of frictional unemployment. It occurs when inability or failure to make the necessary adjustments concentrates unemployment of long duration on displaced workers in particular areas and occupations, while elsewhere jobs are seeking workers of quite different qualifications.

Similarly, aggregate demand and the structure of markets are related to the price level, as follows:

(1) Inflation may result from excessive aggregate demand. Demands for goods and services by consumers, businesses, and governments may add to a total which exceeds the amount that the economy can supply. Prices will be bid up in all markets, and, as business firms try to expand output in order to seize the profit opportunities presented, increases in wages and in costs of materials will follow. The resulting rise in incomes will reinforce and renew the process. In less extreme circumstances, aggregate demand may press hard upon, but not exceed, the economy's productive capacity. Increases in prices and wages may occur nevertheless, reflecting the need to obtain additional output by using labor and capital more intensively—by making greater use of overtime labor, by attracting workers from great distances, by making employment attractive to persons formerly not in the labor force, and by making use of obsolescent capacity and inefficient production techniques.

(2) Upward pressure on prices may originate in those sectors of the economy where competitive forces are weak and large corporations and
unions have a considerable degree of discretion in setting prices and wages. (This discretion, and the public interest in its responsible exercise, are discussed in Chapter 4.) There are two ways in which wage and price decisions in these sectors may put upward pressure on the general price level. First, prices may be increased when demand is not strong in the aggregate or even in the specific industries involved. Because the prices of these industries affect costs elsewhere, increases in their prices tend to spread throughout the economy. Second, prices in these sectors may remain constant in the face of declining demand, although they rise in times of increasing demand. The result in the long run is an upward drift in prices in these industries, which again tends to be transmitted to the whole economy.

Expansion of aggregate demand is clearly the specific remedy for unemployment caused by a deficiency of aggregate demand. Excessive aggregate demand, however, is a source of inflationary pressure. Consequently, the target for stabilization policy is to eliminate the unemployment which results from inadequate aggregate demand without creating a demand-induced inflation. A situation in which this is achieved can appropriately be described as one of "full employment," in the sense that further expansion of expenditure for goods and services, and for labor to produce them, would be met by only minor increases in employment and output, and by major increases in prices and wages. Correspondingly, expansion of demand beyond full employment levels would involve a major sacrifice of the objectives served by price stability, and only a minor gain with respect to the goal of maximum employment.

The selection of a particular target for stabilization policy does not commit policy to an unchangeable definition of the rate of unemployment corresponding to full employment. Circumstances may alter the responsiveness of the unemployment rate and the price level to the volume of aggregate demand. Current experience must therefore be the guide.

In the existing economic circumstances, an unemployment rate of about 4 percent is a reasonable and prudent full employment target for stabilization policy. If we move firmly to reduce the impact of structural unemployment, we will be able to move the unemployment target steadily from 4 percent to successively lower rates.

The recent history of the U.S. economy contains no evidence that labor and commodity markets are in general excessively "tight" at 4 percent unemployment. Neither does it suggest that stabilization policy alone could press unemployment significantly below 4 percent without creating substantial upward pressure on prices.

When unemployment was about 5 percent, as in 1959 before the steel strike and in the first half of 1960, the economy showed many independent symptoms of slack, notably the substantial underutilization of plant and equipment capacity. The wholesale price index fell at a rate of 0.2 percent
a year in the 15 months April 1959–July 1960; and at the consumer level, prices of commodities other than food rose at a rate of only 0.6 percent.

The economy last experienced 4 percent unemployment in the period May 1955–August 1957, when the unemployment rate fluctuated between 3.9 percent and 4.4 percent (seasonally adjusted). During this period, prices and wages rose at a rate which impaired the competitiveness of some U.S. products in world markets. However, there is good reason to believe that upward pressures of this magnitude are not a permanent and systematic feature of our economy when it is operating in the neighborhood of 4 percent unemployment. The 1955–57 boom was concentrated in durable manufactured goods—notably automobiles (in 1955), machinery and equipment, and primary metals. The uneven nature of the expansion undoubtedly accentuated the wage and price pressures of those years. Moreover, the review of the present price outlook in Chapter 4 points to a recent strengthening in the forces making for price stability. The experience of 1955–57 is nevertheless sobering, and experience at higher levels of activity will be needed to indicate whether stabilization policy can now undertake a more ambitious assignment than 4 percent unemployment.

There is no precise unemployment rate at which expansion of aggregate demand suddenly ceases to affect employment and begins to affect solely the general price level. The distinction between aggregate demand effects and structural effects is a matter of degree, both for employment and for the general price level. Sufficiently high levels of aggregate demand can, and have in the past, cut deeply into frictional and structural unemployment. When vacancies are numerous, the time required to find an attractive job is reduced. When there are vacancies everywhere, no one needs to travel far to find a job. And when no applicant for a job meets its exact specifications, the specifications may well be adjusted. Similarly, the degree of inflationary pressure arising from discretionary price and wage setting is not independent of the general strength of demand. Presumably, this pressure could be entirely eliminated by sufficient weakness in aggregate demand if that were the sole objective of stabilization policy.

But while stabilization policy would not be an ineffective cure for either one or the other of these economic ailments, it would be an extremely expensive cure. On the one hand, attempting to reduce frictional and structural unemployment by a highly inflationary expansion of demand would court disaster in our balance of payments position. On the other hand, an attempt to restrict aggregate demand so severely as to eliminate all risk of an increase in the general price level might well involve keeping the economy far below full employment. This would mean sacrifice rather than achievement of both of the major goals that price stability serves: Equity would be sacrificed because the economy as a whole, and the unemployed in particular, would suffer as a result of the manner in which a few individuals
and groups exercise their economic power. Eventually, the balance of payments would also be weakened: under conditions of prolonged unemployment and excess capacity, the investment needed to keep our exports competitive in quality and cost would be unlikely to occur.

The 4 percent interim goal refers to the global measure of unemployment as a percentage of the civilian labor force. An objective stated in terms of any of the other measures of unemployment discussed above would have the same implications for stabilization policy, for the various measures tell the same story with respect to the degree of over-all tightness in the economy. The particular numerical statement of the goal must, of course, change with the unemployment concept used. For example, 4 percent in terms of the global measure is roughly equivalent to a rate of 2½ percent among married men living with their wives; the latter figure, though lower, is at least as serious as the former in its implications for the human consequences of unemployment. Corresponding figures for the other measures of unemployment are 4½ percent among experienced wage and salary workers, 6¼ percent for the full-time equivalent concept, and, if the 4 percent global rate is long sustained, a two-thirds of one percent rate of long-term unemployment.

Unemployment of 4 percent is a modest goal, but it must be emphasized that it is a goal which should be achievable by stabilization policy alone. Other policy measures, referred to in the next section and discussed in detail in Part II of this chapter, will help to reduce the goal attainable in the future below the 4 percent figure. Meanwhile, the policies of business and labor, no less than those of Government, will in large measure determine whether the 4 percent figure can be achieved and perhaps bettered in the current recovery, without unacceptable inflationary pressures.

Full Employment and Structural Unemployment

One way to raise the attainable level of full employment is to reduce frictional and structural unemployment by improving the mobility of labor and the efficiency of labor markets. The amount of frictional and structural unemployment varies from country to country and from time to time within any one country. It has sometimes been suggested that, though a 4-percent unemployment rate was once achievable in the United States with adequate levels of demand, it is no longer a feasible goal because of increasing technological displacement of workers, rapid obsolescence of skills, intractable pockets of depression, and greater numbers of young people swelling the labor force. Careful analyses at the Council and elsewhere—notably in a recent report by the staff of the Joint Economic Committee of the Congress—lend no support to the view that frictional and structural unemployment is a rising proportion of the labor force. It would be wholly wrong, however, to conclude that improvement in the structure of the labor market is not both possible and of high importance.
The displacement of labor through changes in technology, consumer tastes, and the geographic distribution of industry is an inevitable part of the growth of a free and progressive economy. But the level of unemployment corresponding to any given pace of progress depends on the smoothness with which markets function. The size of the pool of unemployed workers, like the size of a pool of water, is determined jointly by the flow into it and the flow out of it. The flow into it depends on the rate at which workers leave jobs or are displaced and on the rate at which new workers enter the labor force without jobs. The flow out depends on the speed with which the unemployed can transfer to jobs vacated by retirement, and to other skills, other industries, and other areas where jobs are available in expanding sectors of the economy.

Economic policy can reduce the size of the pool by providing opportunities for vocational training and retraining, by improving the flow of information about job opportunities, by facilitating the relocation of displaced workers, by acting to reduce and eliminate discriminatory hiring practices, and by assisting in the rehabilitation of depressed areas through the renovation of public facilities and the attraction of viable industry. Administration policies and proposals to attain these ends are discussed in Part II of the present chapter.

The benefits to the United States from the pursuit of such policies are great. In their absence, many of our citizens become, in a real sense, victims of progress; they are condemned to prolonged periods of unemployment which benefit no one and inflict an unjust penalty on an arbitrarily selected few. In their absence, we can expect resistance to technological progress from those who would be harmed by it without prospect of reward.

The returns from such policies do not come instantaneously. For that reason, we should undertake them now, even while unemployment and excess capacity are widespread. There is still time to reap the benefits of the reduction of structural unemployment during the current recovery. But these policies are no substitute for an adequate level of demand. Experience tells us that the pull of expanding job opportunities is a vitally necessary condition for the success of policies to assure a better functioning labor market.

**FULL PRODUCTION**

**Productive Potential**

The Economic Report is required by the Employment Act to set forth "the levels of employment, production, and purchasing power obtaining in the United States and such levels needed to carry out the policy" of the Act. In accordance with the obligation to set forth the levels of production needed to carry out the objectives of the Act, the Council has made the following estimates: (1) In the first quarter of 1961, a gap of $51 billion (1961 prices, annual rate) existed between actual gross national product (GNP) and the output obtainable at full employment. (2) By the last quarter of the year, recovery had narrowed this gap to about $28 billion.
(3) For 1961 as a whole, production averaged $40 billion below potential. 
(4) The production potential for the year 1962 is estimated at $580 billion 
in 1961 prices.

Estimates of this kind cannot, of course, be precise. But they are essential 
in order to specify, within reasonable margins of error, a current measure of 
"maximum production" linked to "maximum employment." They indicate 
clearly that this Nation can achieve a huge bonus of output and income by 
making full use of its resources.

The level of unemployment is a barometer of economic waste. Each 
percentage point of progress toward 4 percent in the unemployment 
rate has meant a gain of roughly 3 percent in total output in postwar periods 
of expansion.

The sources of potential gains in output accompanying full employment 
are given in Table 2, which shows the gain in output that each source could 

<table>
<thead>
<tr>
<th>Source</th>
<th>Associated increment of output</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>40</td>
</tr>
<tr>
<td>Lower unemployment</td>
<td>15</td>
</tr>
<tr>
<td>Larger labor force in response to greater demand</td>
<td>4</td>
</tr>
<tr>
<td>Longer hours of work per man associated with higher utilization</td>
<td>5</td>
</tr>
<tr>
<td>Greater productivity per man-hour associated with higher utilization</td>
<td>16</td>
</tr>
</tbody>
</table>

Source: Council of Economic Advisers.

have contributed if aggregate demand in 1961 had been sufficient to reduce 
unemployment to 4 percent of the labor force. The figures incorporate evi-
dence from postwar relationships among labor input, productivity, and out-
put. An unemployment rate of 4.0 percent instead of 6.7 percent for 1961 
would in itself have increased the number of jobs by 3 percent of actual 
employment. But it would have raised production by much more, about 8 
percent. The reason that improved employment conditions yield magnified 
gains in output is that, in addition to putting the jobless back to work, they 
have a number of other favorable effects on output.

Higher output would have accompanied lower unemployment in the 
following manner:

(1) Actual unemployment in 1961 was 4.8 million persons. Given the 
actual 1961 labor force of 71.6 million persons, 2 million of the unemployed 
would have been at work at an unemployment rate of 4 percent.

(2) At full employment, the labor force would probably have been con-
siderably higher in 1961 and production would have been correspondingly 
increased. Participation in the labor force is encouraged by greater avail-
ability of job opportunities. In recent years of slack activity, the actual
labor force has been abnormally low relative to the number of persons of working age.

(3) Furthermore, a brisker pace of economic activity is accompanied by a higher average number of hours a week worked by those employed. Part-time jobs are converted into full-time employment, and overtime work increases in private nonfarm industry.

(4) Because of these three factors—less unemployment, larger labor force, and longer hours of work—labor input at full employment in 1961 would have exceeded actual labor input by more than 4½ percent, the equivalent of 7 billion man-hours. The added man-hours could have increased production by $24 billion, at existing rates of productivity.

(5) The higher productivity that accompanies fuller use of resources would have meant still more output. In recessions, business firms cannot cut back their labor force as fast as their output falls. Clerical help and sales and supervisory personnel are essentially “overhead.” Moreover, while firms can and do lay off production workers, they do so only with reluctance, preferring both to maintain morale and to avoid the expense of hiring and training new labor when business activity recovers. Recessions thus produce on-the-job underemployment, which is reflected in depressed levels of productivity. In movements toward full employment, recession losses in productivity are regained. At full employment, productivity in 1961 would, according to past evidence, have been 2 to 4 percent higher than it actually was. This gain is equivalent to a $10 to $20 billion increment of GNP. The table shows a $16 billion figure, near the middle of the range, bringing the total estimated gain from all sources to $40 billion.

These calculations receive further support from an alternative approach. Evidence on the relationship between output and unemployment suggests that actual GNP in mid-1955, when the unemployment rate was close to 4 percent, was equal to potential output. The trend rate of growth of GNP, adjusted for changes in unemployment levels, has averaged about 3½ percent in the post-Korean period. Thus the path of potential GNP can be represented by a 3½ percent trend from actual GNP in mid-1955 (Chart 2). The 1961 value of the trend exceeds actual output by $40 billion, which is equal to the sum of the components described above.

The distance between potential and actual GNP was narrowed by $23 billion from the first to last quarter of 1961, as output increased by $37 billion (1961 prices). Among the four factors listed above, the first two, reduction in unemployment and increase in the labor force, contributed less to the gain in production than past experience would have suggested. Of the other two factors, hours of work in nonfarm industries expanded roughly in accord with past behavior; but man-hour productivity achieved an exceptional gain, probably above 6 percent in the three quarters of expansion. As a result, the 7½ percent increase in total production was achieved with a very small increase in employment: nonfarm employment increased by about 1½ percent, but this rise was partially offset by a decline.
CHART 2

Gross National Product, Actual and Potential, and Unemployment Rate

BILLIONS OF DOLLARS *(Ratio scale)

GROSS NATIONAL PRODUCT IN 1961 PRICES

POTENTIAL GAP

ACTUAL


PERCENT

PERCENT

GDP GAP AS PERCENT OF POTENTIAL (Left scale)

UNEMPLOYMENT RATE (Right scale)


* SEASONALLY ADJUSTED ANNUAL RATES.

1/3/1% TREND LINE THROUGH MIDDLE OF 1955.

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

NOTE: A, B, AND C REPRESENT GNP IN MIDDLE OF 1963 ASSUMING UNEMPLOYMENT RATE OF 4%, 5%, AND 6%, RESPECTIVELY.

SOURCES: DEPARTMENT OF COMMERCE, DEPARTMENT OF LABOR, AND COUNCIL OF ECONOMIC ADVISERS.
in agricultural employment. It is primarily because latent productivity was exploited so effectively that unemployment remained high.

The estimated gap of $28 billion, or 5 percent, between potential and actual output in the fourth quarter of 1961 reflected principally a shortfall in persons employed. At the end of the year, there was room for a slight further rise in average weekly hours worked. The impressive gains in productivity during the year brought output per man-hour at the year-end close to the full employment level indicated by past experience. Nevertheless, further gains in productivity as a result of fuller utilization of existing capacity may still be ahead. In any case, further additions to output during the coming year are expected to require larger increases in employment than in 1961.

The unemployment rate will fall in the coming year if, and only if, production continues to rise in relation to the economy’s potential. The prospects for 1962 are discussed later in this chapter.

A full-utilization economy in 1963 would provide nearly 72 million civilian jobs and generate an estimated $600 billion GNP (1961 prices). These figures—5 million more jobs and nearly $80 billion more output than 1961 levels—suggest the magnitude of the opportunity and challenge we face. To help visualize this challenge more concretely, Table 3 presents an illustrative pattern of employment, productivity, and output for the full year 1963 consistent with 4 percent unemployment.

### Table 3.—Employment, output, and productivity, 1961 actual and 1963 illustrative

<table>
<thead>
<tr>
<th>Sector</th>
<th>Employment (millions of persons)</th>
<th>Output (billions of dollars, 1961 prices)</th>
<th>Output per employed person (dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total economy</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>69.4</td>
<td>74.3</td>
<td>521.2</td>
</tr>
<tr>
<td>Agricultural</td>
<td>5.5</td>
<td>5.2</td>
<td>21.0</td>
</tr>
<tr>
<td>Private nonagricultural</td>
<td>54.2</td>
<td>58.8</td>
<td>449.4</td>
</tr>
<tr>
<td>General government</td>
<td>9.7</td>
<td>10.3</td>
<td>50.8</td>
</tr>
<tr>
<td>Addendum:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Civilian employment</td>
<td>66.8</td>
<td>71.6</td>
<td></td>
</tr>
<tr>
<td>Unemployment</td>
<td>4.8</td>
<td>5.0</td>
<td></td>
</tr>
</tbody>
</table>

1 Illustrative pattern projected at 4 percent unemployment; by Council of Economic Advisers.
2 Estimates by Council of Economic Advisers.
3 Includes military.

Sources: Department of Commerce and Department of Labor (except as noted).

### Plant and Equipment Capacity

Periods of slack and recession in economic activity lead to idle machines as well as idle men. Only once since 1949, at the trough of the 1958 recession, was there more excess plant and equipment capacity in U.S. industry than at the start of 1961. While increases in output during the past year have led to fuller use of capital facilities, 1962 begins with considerable room for expanded output from existing plant and equipment,
enough room to permit achievement of the full employment goal. This excess capacity is available to be tapped on demand. It is easier to expand employment at stable prices when tools are already available for new job-holders. Otherwise, capital might act as a bottleneck, obstructing the flow of increased demand for goods into improved employment opportunities for labor.

While unused capital is a reserve source of supply, it dampens the vigor of demand. Although much of investment is undertaken primarily for replacement and modernization, investment for expansion of capacity is important to aggregate demand as well as to economic growth. Incentives to expand plant and equipment are stronger when present facilities are fully utilized. The rate at which existing capacity is utilized also influences the ability of firms to finance investment out of retained earnings. Unused tools are a drag on profits. They yield no return and they impose overhead costs for maintenance and depreciation.

The reliability of measures of productive capacity and capital stock is severely limited by both conceptual and statistical difficulties. But an increasing amount of quantitative evidence is becoming available. Carefully used, it can be very helpful in arriving at the needed qualitative judgments about productive capacity. Two series of data on capital utilization from 1953 to date are presented in Chart 3. One measures the ratio of actual output to capacity output for all manufacturing industry. The other shows the output-capital ratio: the ratio of the value of total output to the value of the stock of plant and equipment, both expressed in 1954 prices, covering all private domestic business except residential housing. Although the two measures are derived by substantially different methods, they move together very closely, offering encouraging evidence of their general validity as measures of capital utilization.

A number of significant points are evident from the chart:

(1) Measures of capital utilization, like unemployment rates, indicate the persistence of slack in the economy over the past five years. Even during the expansion of 1959–60, operating rates and the ratios of output to the stock of capital remained considerably below their 1955–56 levels.

(2) Recessions are clearly marked by excess capacity in plant and equipment. Capital was most underutilized at the 1958 trough; the low point of early 1961 lies about midway between the 1958 rates and those of the 1954 recession. Because capacity grew slowly in 1958–61, excess capacity in early 1961 was smaller than in 1958 even though unemployment was just as large.

(3) Output gains must match the growth of plant and equipment capacity in order to maintain rates of capital utilization. Periods of slow advance in production, like 1956–57 and 1959–60, lead to declining rates of utilization.
(4) Considerable excess capacity remains in the economy despite the rapid rise of utilization rates during 1961. While there is no clear benchmark of full utilization of capital, the operating rates and output-capital ratios attained in late 1955 can serve as a reasonable indication. If GNP had been at its estimated potential level in the last quarter of 1961, capital utilization rates would have been approximately at the levels attained in late 1955. Existing excess capacity in plant and equipment is thus compatible with full employment of the labor force.

(5) Levels of capital utilization have a potent influence on corporate profits. The share of corporate profits in GNP moves closely with the measures of capital utilization, although it swings somewhat earlier. Corporate depreciation allowances have increased rapidly and “gross profits”—net profits and inventory valuation adjustment plus capital consumption allowances—have been maintained during the 1953–61 period. But net profits have declined as a fraction of GNP in recent years; the combination of unrelenting overheads and depressed levels of output can fully account
for this “squeeze.” As corporate capacity is put to fuller use, profits benefit from larger margins as well as expanded sales.

PROGRESS IN 1961

The Situation at the Beginning of the Year

As 1961 began, economic activity was far below its full employment level, and production and income continued to contract through February. By most measures of the decline in economic activity, the 1960–61 recession was the mildest in the postwar period. But the peak reached in May 1960 had followed a year of very slow advance in output and ended the shortest expansion in the postwar period. At the 1960 peak, unemployment and excess capacity were higher than at any prior postwar peak. Unemployment rates were higher during the 1960–61 recession than during the slumps of 1948–49 and 1953–54; in this respect, the recession was almost as severe as that of 1957–58.

The rate of use of existing facilities in late 1959 and early 1960 was not conducive to substantial further increases in business fixed investment, nor were monetary conditions encouraging. Although there was a brief interlude in the first quarter of 1960 when investment demand rose sharply, this buoyancy was to a large extent a temporary aftermath of the steel strike of 1959. As orders, sales, and profits proved disappointing, investment in both fixed capital and inventories was cut back.

During this period, government fiscal programs gave little support to aggregate demand. Total Federal expenditures, on income-and-product account, showed little change between mid-1959 and mid-1960 as Federal purchases of goods and services actually declined. In January 1960, Federal social insurance taxes were increased by about $2 billion a year. Indeed, the sharp change in the relationship between Federal Government receipts and expenditures was perhaps the most important factor in choking off the recovery.

The recession followed the same pattern as previous postwar downswings. With activity weakening, purchases of goods were cut back throughout the private economy. Inventory investment, as usual, displayed the largest decline among major components of GNP (Table 4). The decline of inventories, as well as of other major categories of expenditure, was concentrated in durable goods. Correspondingly, a decline of 12 percent in durable goods manufacturing accounted for most of the fall in industrial production from May 1960 to February 1961. Unemployment, which had been 5.1 percent (seasonally adjusted) of the civilian labor force in May, rose to 6.8 percent in February.

Once the contraction began, it was certainly moderated, and perhaps shortened, by a rise in outlays at all levels of government. The automatic stabilizers in the Federal fiscal system contributed to the stability of personal consumption expenditure during the recession, as transfer payments rose

56
### TABLE 4.—Changes in output, income, and employment over the three quarters of the 1960–61 recession

<table>
<thead>
<tr>
<th>Item</th>
<th>Cyclical peak: Second quarter 1960</th>
<th>Cyclical trough: First quarter 1961</th>
<th>Change, peak to trough</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Output (1961 prices):</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross national product</td>
<td>514.2</td>
<td>502.9</td>
<td>−11.3</td>
</tr>
<tr>
<td>Personal consumption expenditures</td>
<td>333.9</td>
<td>331.7</td>
<td>−2.2</td>
</tr>
<tr>
<td>Gross private domestic investment:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed investment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Residential nonfarm construction</td>
<td>69.5</td>
<td>64.2</td>
<td>−5.3</td>
</tr>
<tr>
<td>Other construction</td>
<td>19.9</td>
<td>20.6</td>
<td>0.7</td>
</tr>
<tr>
<td>Producers' durable equipment</td>
<td>28.4</td>
<td>24.2</td>
<td>−4.2</td>
</tr>
<tr>
<td>Change in business inventories</td>
<td>5.4</td>
<td>−4.0</td>
<td>−9.4</td>
</tr>
<tr>
<td>Net exports of goods and services</td>
<td>3.9</td>
<td>5.3</td>
<td>2.3</td>
</tr>
<tr>
<td>Government purchases of goods and services</td>
<td>102.3</td>
<td>108.7</td>
<td>6.4</td>
</tr>
<tr>
<td>Federal</td>
<td>54.1</td>
<td>54.9</td>
<td>0.1</td>
</tr>
<tr>
<td>State and local</td>
<td>47.9</td>
<td>50.8</td>
<td>2.9</td>
</tr>
<tr>
<td><strong>Income (current prices):</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disposable personal income</td>
<td>352.7</td>
<td>354.3</td>
<td>1.6</td>
</tr>
<tr>
<td>Corporate profits after taxes</td>
<td>23.3</td>
<td>20.0</td>
<td>−3.3</td>
</tr>
<tr>
<td><strong>Employment:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total civilian employment</td>
<td>67.0</td>
<td>66.8</td>
<td>−0.2</td>
</tr>
<tr>
<td>Employment in nonagricultural establishments</td>
<td>54.6</td>
<td>53.5</td>
<td>−1.1</td>
</tr>
<tr>
<td>Private</td>
<td>46.1</td>
<td>44.9</td>
<td>−1.2</td>
</tr>
</tbody>
</table>

**Note:**—Detail will not necessarily add to totals because of rounding. See Tables B-2, B-11, B-15, B-19, and B-24.

**Sources:** Department of Commerce and Department of Labor.

by $3.0 billion and personal taxes fell by $0.7 billion (annual rates) to offset much of the fall in private wages and salaries resulting from lower employment.

**Recovery During the Year**

By the end of 1961, production and income had improved markedly, and most economic indicators had surpassed their 1960 peaks. In the final quarter of 1961, GNP, measured in constant prices, was 7½ percent higher than in the first quarter, and about 5 percent above the peak attained in the second quarter of 1960 (Tables 4 and 5). The only major category of expenditure that was lower than in the second quarter of 1960 was expenditure for producers' durable equipment. Industrial production in December exceeded its low point of February by 13 percent, and was 4 percent above the previous peak attained in January 1960.

The increase of $41 billion (current prices, annual rate) in GNP from the first to last quarters of 1961 distributed substantial gains in income widely through the economy. Personal income grew by $24 billion. Wage and salary disbursements expanded by $19 billion and accounted for...
TABLE 5.—Changes in output, income, and employment over three quarters of expansion, 1961

[Seasonally adjusted]

<table>
<thead>
<tr>
<th>Item</th>
<th>1961 First quarter (cyclical trough)</th>
<th>Fourth quarter ¹</th>
<th>Change, trough to fourth quarter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Output (1961 prices):</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross national product</td>
<td>502.9</td>
<td>546.2</td>
<td>37.3</td>
</tr>
<tr>
<td>Personal consumption expenditures</td>
<td>331.7</td>
<td>347.8</td>
<td>16.1</td>
</tr>
<tr>
<td>Gross private domestic investment:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed investment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Residential nonfarm construction</td>
<td>64.2</td>
<td>71.4</td>
<td>7.2</td>
</tr>
<tr>
<td>Other construction</td>
<td>10.4</td>
<td>23.2</td>
<td>3.8</td>
</tr>
<tr>
<td>Producers' durable equipment</td>
<td>20.6</td>
<td>25.2</td>
<td>-4</td>
</tr>
<tr>
<td>Change in business inventories</td>
<td>-4.0</td>
<td>4.5</td>
<td>8.5</td>
</tr>
<tr>
<td>Net exports of goods and services</td>
<td>5.3</td>
<td>4.0</td>
<td>-1.8</td>
</tr>
<tr>
<td>Government purchases of goods and services</td>
<td>108.7</td>
<td>112.5</td>
<td>6.8</td>
</tr>
<tr>
<td>Federal</td>
<td>54.9</td>
<td>59.9</td>
<td>5.0</td>
</tr>
<tr>
<td>State and local</td>
<td>50.8</td>
<td>52.7</td>
<td>1.9</td>
</tr>
<tr>
<td>Income (current prices):</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disposable personal income</td>
<td>354.3</td>
<td>375.6</td>
<td>21.3</td>
</tr>
<tr>
<td>Corporate profits after taxes</td>
<td>20.0</td>
<td>22.8</td>
<td>13.8</td>
</tr>
</tbody>
</table>

| Employment:                              |                                     |                  |                                  |
| Total civilian employment                | 66.8                                | 66.9             | 0.1                              |
| Employment in nonagricultural establishments| 53.5                              | 54.5             | 1.0                              |
| Private                                  | 44.9                                | 45.5             | .6                               |

¹ Preliminary estimates of output and income by Council of Economic Advisers.
² Third quarter data and change from first to third quarter.

NOTE.—Detail will not necessarily add to totals because of rounding.
Sources: Department of Commerce and Department of Labor (except as noted).

most of the gain in personal income. Incomes from dividends and business ownership also rose. Farm operators’ net income from farming increased from $12.0 billion in 1960 to $13.1 billion in 1961, and net income per farm rose by nearly $350. Disposable personal income (after taxes) grew by $21 billion over the three quarters of expansion, adding $92 to average per capita spendable income.

The effect of rising output is strikingly shown in the $3.8 billion increase—nearly 20 percent—in the annual rate of corporate profits after taxes from the first to the third quarter. By all indications, corporate profits rose further in the fourth quarter and probably exceeded $50 billion before taxes and $25 billion after taxes.

Higher private incomes meant larger tax liabilities: Federal receipts in the income-and-product budget rose by about $10 billion (annual rate) in the three quarters of expansion, and the yield of State and local taxes grew by $3 billion.

The recovery was paced by a prompt and sharp reversal in inventory investment, the volatile inventories of manufacturers of durable goods ac-
counting for a major share of the movement. During recessions, output falls below final sales as some orders are filled out of excessive stocks. The end of inventory liquidation in itself raises production to the level of sales. And rising sales and orders in a period of economic recovery encourage the accumulation of stocks, creating further gains in production. In 1961, this characteristic switch from liquidation to accumulation occurred very promptly, only one month after the trough in over-all activity, and was a major factor in the $15 billion expansion of GNP in the second quarter. Incentives for restocking did not arise wholly independently; they were provided in large part by evidence of a strengthening in final purchases, i.e., expenditures for GNP other than for inventory accumulation.

A key element in the rise of final demand was the increase in expenditures at all levels of government. The upward trend of State and local government purchases continued unabated. The promotion of economic recovery was a major aim of Federal budget policy in 1961. Scheduled obligations and expenditures were speeded up in the numerous ways listed in Part II and the Appendix to this chapter. Additional outlays came from new Administration programs—some to assist individuals and areas hit by economic recession and others to meet national needs of high priority. Furthermore, in the spring and summer of 1961 when overriding national security requirements led to increased expenditures for defense and space activities, the existence of unutilized manpower and capital ruled against an increase in tax rates. A careful appraisal of the direct and indirect effects of increased Federal activity indicates that it was a major force—probably the principal driving force—of the recovery of 1961.

Investment in nonresidential construction and producers' durable equipment, taken together, rose at an annual rate of $3.4 billion (1961 prices) from the first to the last quarter of 1961, both responding to and contributing to the expansion (Table 5). With improving rates of utilization of capacity, larger corporate profits, and readily available credit, business fixed investment began to rise in the second quarter of 1961. In contrast, business capital outlays had continued to decline during two quarters of rising total output in both 1954 and 1958.

Residential nonfarm construction, which had fallen since mid-1959, picked up in the early months of 1961 and continued to rise through the year. Although the rate of new family formation has been relatively low, and vacancy rates have continued to rise steadily, increasing disposable incomes and favorable financial and liquidity conditions have stimulated home building. Through much of 1960 and well into 1961, individuals continued to increase their volume of liquid assets. Funds for conventional, FHA, and VA mortgages were readily available; mortgage yields declined moderately throughout the recession and into the summer of 1961 and remained fairly stable the rest of the year.

The favorable financial environment for business investment and residential construction reflected the monetary and credit policies of the
Government. These policies have facilitated the flow of funds into investment and have contributed to a stability of interest rates unusual for a year of recovery.

Exports in the fourth quarter were $0.8 billion (annual rate) higher than in the first quarter. But outlays on imports, partly to rebuild inventories, rose by $2.1 billion, reducing net exports by $1.3 billion. Net exports is the one component of GNP which tends to fall as business activity improves cyclically.

Consumer outlays accounted for somewhat less than half the increase in GNP from the first to the fourth quarter. Until the closing months of the year, consumer spending did not quite keep pace with disposable income. The ratio of personal saving to personal disposable income rose from 6.7 percent in the first quarter to 7.3 percent in the third. In the fourth quarter, however, consumption did keep pace with income and expanded by $8.0 billion (current prices, annual rate). Demand for new automobiles sparked a rise in the fourth quarter of $3.2 billion (annual rate) in outlays for consumer durable goods, which finally surpassed the peak that had been reached in the second quarter of 1960.

The gains in production, income, and employment during 1961, in comparison with previous expansions, are shown in Charts 4 and 5. Chart 4 displays the rise of GNP from its lowest quarter in each recession. In

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**CHART 4**

**Real Gross National Product in Four Postwar Recoveries**

![Chart](https://fraser.stlouisfed.org/pubs/1171/1962-06-05-RED_d4-001.png)

1//BASED ON SEASONALLY ADJUSTED DATA.
SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.
CHART 5

Employment, Production, and Income in Four Postwar Recoveries

CYCLICAL TROUGH = 100

EMPLOYMENT IN NONAGRICULTURAL ESTABLISHMENTS

120

110

100

90

0 2 4 6 8 10 12 14

MONTHS AFTER CYCLICAL TROUGH

1949-50
1954-55
1958-59
1961

PERCENT OF CIVILIAN LABOR FORCE

UNEMPLOYMENT RATE

100

110

120

130

0 2 4 6 8 10 12 14

MONTHS AFTER CYCLICAL TROUGH

CYCLICAL TROUGH = 100

INDUSTRIAL PRODUCTION

130

120

110

100

0 2 4 6 8 10 12 14

MONTHS AFTER CYCLICAL TROUGH

1949-50
1954-55
1958-59
1961

PERSONAL INCOME

130

120

110

100

0 2 4 6 8 10 12 14

MONTHS AFTER CYCLICAL TROUGH

1949-50
1954-55
1958-59
1961

NOTE: INDEXES AND RATE BASED ON SEASONALLY ADJUSTED DATA.

SOURCES: DEPARTMENT OF LABOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, AND DEPARTMENT OF COMMERCE.
the three previous cycles, the trough quarter for GNP came before the month of the cyclical trough. In 1961 the cyclical trough, in February, was in the middle of the quarter of lowest GNP. In Chart 5 the reference point for all series is the cyclical trough month. These differences in timing must be taken into account in comparisons of recoveries. There are also differences in the composition of output: for example, the 1958–59 upswing was more heavily concentrated in industrial production than the current recovery.

On the whole, increases in production and income during the present expansion of economic activity compare favorably with the two preceding periods of expansion. However, these gains were not matched by equal improvements in employment and unemployment. As noted above, one of the principal reasons was that productivity gains during 1961 exceeded those of earlier expansions. The year ended with unemployment at 6.1 percent of the civilian labor force (seasonally adjusted).

In summary, real output rose during the 1961 recovery at an annual rate of 10 percent. The gap between actual output and estimated potential has been narrowed by $23 billion in three quarters; labor and capital have been more efficiently utilized; and widespread gains in income have been secured. The Nation has adjusted smoothly and easily to the marked change of pace: no evidence of strain can be found, no bottlenecks have developed, no excessive backlogs of orders have appeared. And prices have been exceptionally stable, as Chapter 4 makes clear. Although the economy at the end of 1961 was still short of full employment, the experience during the year was gratifying and reassuring on many counts. And it demonstrated the ability of the economy to advance efficiently at a rapid pace when the underlying strength of private demand is reinforced by appropriate Federal fiscal and monetary policies.

**Outlook for 1962**

The Employment Act of 1946 requires an estimate of “current and foreseeable trends in the levels of employment, production, and purchasing power.” Although the difficulties and risks of economic forecasting are well known, neither government nor private enterprise can conduct its affairs, develop its policies, and make its decisions without economic projections—without making the best estimates that economic and statistical tools permit of the economic framework within which it will have to operate in the future. For example, it would be impossible to formulate either Federal or State budgets without projections of future levels of income and business activity and the tax revenues they will produce. In the Budget Message, GNP for 1962 is projected at $570 billion (current prices), a rise of nearly $50 billion, or almost 9 1/2 percent, over 1961. A somewhat higher figure is likely if the Congress enacts promptly the Administration’s proposed tax credit for investment. This section presents, with full recognition of the
margins of error inherent in economic projections, the appraisal of the economic outlook underlying the budget.

The momentum of the current recovery will carry the economy to new records in production, income, and employment during 1962. In the closing months of 1961, private demand was rising briskly. The resulting gains in consumer incomes, profits, business inventory requirements, and orders for durable goods will generate further increases in spending and business activity in the coming months. Broad advances in the private economy will be reinforced by a continued upward trend in Federal, State and local government outlays.

The favorable prospects for private demand, together with current economic programs and proposals of the Administration, point to a strong and sustained expansion. The percentage gain in GNP (current prices) in 1962 over the 1961 level can realistically be expected to match the increases of 8½–9½ percent in 1955 and 1959. Those two years, like 1962, were the first full years of recovery from recession.

Expansion in GNP in 1962 is expected to be somewhat more moderate than the annual rate of 11 percent (current prices) attained over the past three quarters. But it is anticipated that output will continue to catch up with potential, reducing slack and unemployment. Substantial increases are expected in all major categories of expenditure. The expected total increase is made up, very roughly, of the following parts: one-half, consumer outlays; one-fifth each, government purchases and private fixed investment; and one-tenth, additions to inventories.

Survey of Major Categories of Expenditure

The rationale for this appraisal of the outlook may be indicated by a brief survey of the key components of GNP.

Consumption. The ratio of total consumer expenditure to personal disposable income, 93.0 percent in 1961, is expected to rise slightly in 1962. The proportion of income spent on nondurable goods and services typically declines during expansion and, this year, will probably fall below the 81.3 percent recorded in 1961. In prosperous periods, consumers devote a larger share of their incomes to increasing their wealth. But at the same time they show a preference for accumulating wealth in the form of consumer durable goods. The current strong liquid position of households is likely to moderate their desire for additional liquidity and to reinforce demands for durable goods this year. The brisk sales of automobiles in the fourth quarter of 1961 also point in this direction. An increase in expenditures for durables from 11.6 percent of disposable income in 1961 to some 12½ percent, approaching the proportions recorded in 1959 and 1960, will probably outweigh the slight decline to be expected in the fraction devoted to nondurables and services.

Measured absolutely, rather than as shares of disposable income, all components of consumer expenditure seem headed upward in 1962. Per-
sonal disposable income is likely to grow substantially. It will probably advance at a somewhat slower rate than GNP for the following reasons: (1) Corporate profits rise sharply in cyclical upswings, and dividend payments lag behind. (2) Government transfer payments to individuals are held down when unemployment declines. (3) Collections from progressive personal income taxes rise somewhat faster than personal incomes. But disposable income will still absorb more than half of the dollar gains in GNP, and consumer expenditure will account for about half of the total increment in expenditure. Consumption is now about 65 percent of GNP; no economic expansion can go far without support from consumers, and every expansion provides substantial income gains for households. A rise of $50 billion in GNP for 1962 would be accompanied by an increase of about $100 in consumption per capita, permitting significant advances in standards of living.

**Government.** State and local governments can be expected to add about $1 billion a quarter to their purchases of goods and services, continuing their steady upward trend. Federal purchases of goods and services will rise during 1962 but more slowly than over the past year. The average increase during the course of 1962 seems likely to be $1 billion a quarter, compared with $1.7 billion in 1961. New Federal obligations, which have some effect on business activity before the outlays they foreshadow, are expected to rise by $5 billion in the year starting next July 1—after a rise of $12 1/2 billion in the current fiscal year.

**Inventories.** Inventory-sales ratios have declined markedly during this expansion, as is usual in the first year of an upswing. The ratio of inventories to GNP fell by about 5 percent over the last three quarters of 1961. More rapid accumulation is to be expected—and welcomed—in the near future. Analysis supported by prior cyclical experience suggests that inventories will soon begin catching up with total output. If they were to rise at a quarterly rate of 2 percent, inventory investment would attain an annual rate of more than $8 billion some time in 1962.

The threat of a midyear steel strike may produce added stockpiling this spring. In the absence of a prolonged strike, the main effect would be on the pattern of activity during the year, with the second quarter stronger and the third quarter correspondingly weaker. Although the year-end levels and the full year totals might not be seriously affected, this abnormal factor in inventory behavior would increase the difficulties of appraising the real strength of the economy. A long strike, of course, could seriously imperil the prospects for continued vigorous expansion.

Quite apart from the steel situation, inventory investment is likely to reach its peak before the end of 1962 and cannot be expected to be a significant expansionary factor in the latter half of this year.

**Residential construction.** With the aid of continued credit ease and increased household incomes, residential construction ended 1961 with a rate of activity $2 billion above the average for the year. Further mod-
erate gains are likely, in part from additions and alterations and in part from new housing starts. Industry and government specialists have predicted housing starts of 1.4 million in 1962. Mortgage availability will influence housing demand considerably. If funds remain readily available, gains in household incomes are likely to strengthen the demand for new homes.

Business fixed investment. As Chart 3 shows, rates of capital utilization have been more favorable to investment demand in the last year than in 1958. Business outlays for durable equipment and nonresidential construction have risen more promptly and more vigorously to date than in the comparable stage of the preceding expansion. Incentives to invest for modernization and replacement purposes are also favorable. Furthermore, business fixed investment is volatile; in peacetime expansions, it usually rises as a fraction of GNP. Even the weak expansion of 1958-60 produced a 22 percent increase in capital outlays from their low in the third quarter of 1958 to their peak in the second quarter of 1960. The same performance in the current expansion would mean a rise of $6 billion from the last quarter of 1961 to the last quarter of 1962. And the major determinants of investment—corporate liquidity and profit rates, capacity measures, conditions in financial markets—point to more strength than in the last expansion. It seems probable that capital outlays in 1962 will surpass their 1958-60 performance.

Prospects for plant and equipment investment are difficult to assess quantitatively. Recent surveys suggest that businessmen have not yet planned any major expansion of productive facilities. But improved economic conditions have consistently led to substantial upward revisions of plans. Whether business fixed investment as a share of GNP, 8.9 percent in 1961, will approach the 1956 and 1957 figure of 10.7 percent or even substantially surpass the 1960 figure of 9.3 percent cannot be foretold. Much depends on the extent to which excess capacity declines over the next few quarters and on the willingness of businessmen to count on continued prosperity. Capital outlays will also be significantly influenced by the state of financial markets. The financing of investment will be facilitated by the rising flow of internal funds from retained earnings and depreciation allowances. But corporate investment is almost certain to exceed corporate saving in 1962. Corporations as a whole have strengthened their liquidity position, in part by long-term financing ahead of investment needs in 1961. Nevertheless, they will probably require substantial net external financing this year, involving an increase in the security holdings of households and financial institutions. Monetary policy can facilitate this external financing.

An important stimulus to capital outlays would be provided by enactment of the proposed tax credit of 8 percent on expenditures for new durable equipment. This measure would raise significantly the after-tax return on new investment. Enactment of the tax credit will help assure sufficient strength in this central component of demand at the crucial stage of the recovery.
Another favorable factor for the later stage of recovery is the planned revision by the Treasury of guideline schedules of depreciation on plant and equipment. The revision will incorporate available current information about the economic lives of capital goods and the effects of technological change on obsolescence.

In 1955–57, capital outlays amounting to more than 10 percent of potential and actual GNP led to an annual rate of growth of slightly less than 4 percent in the business capital stock. Because total output did not grow at an equal pace after 1955, excess capacity developed and capital outlays were sharply reduced in the 1957–58 recession. The excess capacity that emerged is more accurately attributed to underbuying than to overbuilding. If purchases by consumers and government had been sufficient to keep the economy fully employed, rates of capital utilization would not have fallen. Business firms would have had sustained incentives to enlarge their productive facilities at the rate of nearly 4 percent a year. Better performance in maintaining full use of resources could justify business fixed investment amounting to 10 percent or more of the Nation’s output.

Prospects for Full Employment

This appraisal of the prospects for production and income implies an unemployment rate of 5 percent or somewhat lower at the end of 1962, but not as low as 4 percent.

The achievement of 4 percent unemployment by mid-1963 requires a gain of about 11 percent in GNP (in constant prices) over the coming year and a half. This pace of advance would permit smooth and efficient adjustments, avoiding bottlenecks that might generate serious upward pressures on prices. It would also allow a gradual transition toward the rates of expansion that must be expected when full utilization is restored and output can no longer rise more rapidly than productive potential. A continued upward movement for more than two years with an over-all gain of 20 percent in real GNP would represent a very strong expansion. But a less ambitious rate of recovery to full employment would prolong the waste of unused resources without gaining appreciably greater assurance of stable prices.

While this rate of expansion seems feasible in the light of the prospects for private demand and Administration policies designed to promote expansion at a desirable pace, any appraisal of the economic outlook must take into account a wide range of possible outcomes. Weakening of consumer demand or lack of investment enthusiasm by business firms could endanger the prospective gains of 1962 and slow down the expansion. Because of the growth in the labor force and productivity, 1962 could achieve new highs in output and even in employment without any reduction in the currently excessive rate of unemployment. Large and continuing gains are needed to
bring output up to the economy's potential and to reduce unemployment to 4 percent of the labor force for the first time since 1957.

An expansion that slows down prematurely is less likely to be lasting. A slowdown, or even an expected slowdown, in the growth of sales can diminish incentives to enlarge productive capacity and inventories. A decline in capital spending and inventory accumulation can convert a slowdown into a downturn. For this reason, prospects for a lasting expansion rest heavily on the vigor of the upswing over the next few quarters.

The buildup of inventories that is expected in the near future will contribute substantially to household incomes and to the strength of consumer demand. But by late 1962, continued advance will depend heavily on the ability of fixed investment outlays to replace inventories as a key expansionary force. If the expansion is vigorous earlier in the year, utilization rates will be favorable to investment demand in late 1962, and, therefore, to the continuation of the expansion itself.

On the other hand, private demand can rise too fast or too far. Too rapid an expansion may strain the adjustment mechanisms of the economy. In a dynamic economy, patterns of output and employment change from one cycle to the next. It takes time to re-employ the jobless and to return efficiently to full utilization of capacity. Hence, a very rapid expansion of demand might involve price increases, bottlenecks, and inefficiencies that could be avoided in a more gradual rise to the same levels. The current expansion has an enviable record to date: with a 10 percent annual rate of increase of real output, it has substantially narrowed the gap between actual and potential output; at the same time, the movements of prices, inventories, and orders show none of the symptoms of strain that would be associated with excessive speed. If demand for consumer durable goods and business capital formation were quickly to attain the same strength relative to incomes as in 1955, reasonable speed limits might be violated. In that event, full employment might be achieved sooner but policy might have to contend with excess demands and inflationary pressures.

Still another challenge to policy might come from unexpected behavior of unemployment relative to output. Given continued growth of potential output along the 3½ percent trend discussed earlier, the achievement of full employment in mid-1963 would be associated with GNP of $600 billion in 1961 prices. Deviations from historical trends in the size of the labor force, average hours of work, and man-hour productivity can alter the relationship between output and unemployment. Full utilization of resources may correspond to a somewhat higher or somewhat lower GNP. In particular, the effects of measures (discussed in Chapter 2) to increase the rate of growth of productivity, while adding to investment demand during the expansion, may raise the productive potential output of the economy above its current trend as early as 1963.
Stabilization policy has contributed significantly to the gratifying progress of 1961 and to the favorable prospects for 1962. Policy will continue to promote progress toward full employment, remaining alert to unforeseen developments which might throw the economy off course. The flexibility in existing policy instruments can be used to good advantage, as it was in 1961. Furthermore, Administration proposals now before the Congress would greatly enhance the ability of stabilization policy to counter threats of oncoming recession with speed and vigor. The record of stabilization policy in 1961 and its tasks for 1962 are discussed in the remaining part of this chapter.

PART II: POLICIES FOR MAXIMUM EMPLOYMENT AND PRODUCTION

In Part I of this chapter, the progress of the economy in 1961 and the prospect for further progress in 1962 were reviewed in terms of the objectives of maximum employment, production, and purchasing power. Part II describes more fully and specifically how government policy can, does, and will promote progress toward these goals. Two major kinds of government policy are involved: measures for economic stabilization, which influence the total volume of spending; and measures to reduce structural unemployment and underemployment by better mutual adaptation between available jobs and available workers.

ECONOMIC STABILIZATION

Insufficient demand means unemployment, idle capacity, and lost production. Excessive demand means inflation—general increases in prices and money incomes, bringing forth little or no gains in output and real income. The objective of stabilization policies is to minimize these deviations, i.e., to keep over-all demand in step with the basic production potential of the economy.

Stabilization does not mean a mere leveling off of peaks and troughs in production and employment. It does not mean trying to hold over-all demand for goods and services stable. It means minimizing deviations from a rising trend, not from an unchanging average. In a growing economy, demand must grow in order to maintain full employment of labor and full utilization of capacity at stable prices. The economy is not performing satisfactorily unless it is almost continuously setting new records of production, income, and employment. Indeed, unless production grows as fast as its potential, unemployment and idle capacity will also grow. And when the economy starts from a position well below potential, output must for a time grow even faster than potential to achieve full utilization.
The Postwar Record

Despite the recessions of recent years and the inflationary excesses of the early postwar years, the postwar record of economic stabilization is incomparably better than the prewar. The economy fluctuated violently in 1919-21 and operated disastrously far below potential from 1930 to 1942. The 1929 level of GNP, in constant prices, was not exceeded, except briefly in 1937, until 1939. The difference between the 17 percent unemployment of 1939 and the 3 percent rate 10 years earlier is a dramatic measure of the growth of the labor force and productivity even during depression. Since the war, the economy's detours from the path of full employment growth have been shorter in both time and distance. There have been four recessions, but none of them has gotten out of hand, as did the decline of 1929-33. All of the declines have been reversed within 13 months, before unemployment reached 8 percent of the labor force. For this improved performance there are several reasons.

First, the war and preceding depression left business firms and households starved for goods. Further, wartime earnings coupled with scarcities of civilian goods, rationing, and price control, saturated business firms and consumers with liquid assets. For these legacies of depression and war, the economy paid a price in the inflations of 1946-48 and 1950, with delayed effects throughout the past decade.

Second, the structure of the economy was reformed after 1933 in ways which substantially increased its resistance to economic fluctuations. The manner in which government tax revenues and income maintenance programs serve as automatic or "built-in" economic stabilizers is described below. The New Deal strengthened and reformed the Nation's banking and financial system with the help of new governmental credit institutions, deposit insurance, and loan and guarantee programs. These have virtually eliminated the possibility that economic declines will be aggravated by bank failures, foreclosures, and epidemic illiquidity.

Third, there is a significantly improved understanding of the manner in which government fiscal and monetary tools can be used to promote economic stability. Under the Employment Act and the climate of opinion which it symbolizes, the Government has been expected to assume, and has assumed, greater responsibility for economic stabilization.

Finally, businessmen and consumers no longer regard prolonged and deep depression as a serious possibility. They generally expect recessions to end quickly; they anticipate a long-term upward trend in the economy; and they spend and invest accordingly. This stability of expectations is in part the result of stability achieved in fact, and reflects general understanding of the structural changes which have contributed to it. But expectations of stability are also a cause of stability—nothing succeeds like success.
Achieving Greater Stability

While our postwar performance is a great advance over that of prewar years, it is still far from satisfactory. We have had no great depression, but we have had four recessions. Even the relatively short and mild recessions of the postwar period have been costly. In the last decade, the Nation has lost an estimated $175 billion of GNP (in 1961 prices) by operating the economy below potential. Industrial production has been below its previous peak nearly half the time since 1946.

There is general agreement that economic fluctuations in the United States are intensified by—if not always caused by—a rhythm in inventory investment, alternating between periods in which stocks are accumulating at an excessively high rate and periods in which they are being liquidated. But it is not beyond hope that stabilization measures, both automatic and discretionary, can be strengthened in force and improved in timing so as to compensate for inventory swings better than has been true in the past. If this is done the swings themselves will be dampened.

The possible gains from improved economic stabilization are impressive. Losses of production, employment, and consumption will be cut. More saving and investment will be realized, contributing steadily to the long-run growth of production potential. Business, consumer, and labor decisions will allocate resources more efficiently when they respond less to cyclical prospects and more to long-run developments. There will be less need and less justification for restrictive practices which are now designed to provide sheltered positions in markets periodically hit by recession.

It is true that an economy operating steadily at a high level of employment, with only limited excess plant capacity, is more subject to the risks of price increases than an economy with heavy unemployment and large unused capacity. However, the dampening of economic fluctuations may itself help to counter this tendency. Cyclical fluctuations have been exerting a "ratchet effect" on prices; costs and prices have been relatively inflexible downward in recessions but have been responsive to increases in demand during recoveries. Cyclical swings in total spending also tend to be accompanied by sharp and transitory shifts in the composition of spending. Because prices and costs respond more readily to upswings than to downswings, these rapid changes in the composition of demand impart an upward bias to the whole price level. These sources of upward price bias will tend to be reduced as a more even pace of advance is achieved.

To capitalize on the potential gains of stabilization requires skillful use of all economic policy, particularly budgetary and monetary policy.

The Federal Budget and Economic Stability

Federal expenditures and taxes affect total employment and production by influencing the total volume of spending for goods and services. Direct Federal purchases of goods and services are themselves part of total demand for national output. In addition, the Federal Government makes "transfer
payments” to individuals, for which no current services are rendered in return. Examples are social security and unemployment insurance benefits, and veterans compensation and pension benefits. Both purchases of goods and services and transfer payments add to private incomes and thereby stimulate consumption and investment. Federal taxes, on the other hand, reduce disposable personal and business incomes, and restrain private spending.

By increasing the flow of spending, additional Federal outlays—with tax rates unchanged—have expansionary effects on the economy. Whether an expansion in spending—government or private—leads mainly to more output or mainly to higher prices depends on the degree of slack in the economy. Under conditions of widespread unemployment and excess capacity, businessmen respond to higher demand by increasing production; under conditions of full employment, prices rise instead. In the slack economy of 1961, for example, additional demand from both private and public sources was readily converted into increased production.

Built into the Federal fiscal system are several automatic defenses against recession and inflation. Given the tax rates, tax revenues move up and down with economic activity, since most taxes are levied on private incomes or sales. Indeed, tax revenues change proportionally more than GNP. Furthermore, certain Federal expenditures, such as unemployment compensation payments, are automatically affected by the state of the economy. Economic fluctuations, therefore, result in substantial changes in Federal expenditures and revenues, even when basic expenditure programs and tax rates remain unchanged. With the present system of tax rates and unemployment compensation payments, a one-dollar reduction in GNP means a reduction in Federal tax receipts and an increase in transfer payments totaling about 30 cents. Therefore, private incomes after Federal taxes fall by only 70 cents for each reduction of one dollar in GNP. For this reason, any initial decline in spending and output is transmitted with diminished force to other sectors of the economy.

These automatic or built-in stabilizers moderate the severity of cyclical swings in the economy. If the forces causing a downturn in economic activity are weak and transient, the automatic stabilizers cushion the severity of the decline and give the basic recuperative powers in the private economy a better opportunity to produce a prompt and full recovery.

But if the forces causing the downturn are strong and persistent, the built-in stabilizers may not suffice to prevent a large and prolonged recession. Furthermore, they are blindly symmetrical in their effects. When economic activity quickens after a slump, the rise in Federal revenues begins immediately and slows the recovery in employment and incomes. For these reasons, the task of economic stabilization cannot be left entirely to built-in stabilizers. Discretionary budget policy, e.g., changes in tax rates or expenditure programs, is indispensable—sometimes to reinforce, sometimes to offset, the effects of the stabilizers.
To be effective, discretionary budget policy should be flexible. In order to promote economic stability, the Government should be able to change quickly tax rates or expenditure programs, and equally able to reverse its actions as circumstances change. Failure to arrest quickly a downturn in income, production, and employment may shake the faith of firms and households in prompt recovery and thereby lead to a cumulative decline. Delay in countering inflationary pressures may permit the development of a self-propelling speculative boom, with disruptive consequences to the domestic economy and the balance of payments. If moderate fiscal action can be taken quickly and can be speedily reversed when circumstances warrant, the dangers of overstimulating or overrestricting the economy are much smaller than if fiscal responses are sluggish and difficult to reverse.

Fiscal policy can be made a more flexible and more powerful tool of economic stabilization by means that do not change the basic structure and level of taxation or the long-run size and composition of Federal expenditure programs. Changes in the basic structure and level of taxation should be made by the Congress with full deliberation in the light of the many relevant considerations, including the long-run revenue needs of the Government, equity among individuals and groups, and the effects of various taxes on economic efficiency and growth. Similarly, changes in the magnitude and content of government expenditures should represent the considered judgment of the people and the Congress on national priorities.

For purposes of economic stabilization all that is needed of tax policy is temporary variation in the general level of tax rates within the existing structure, and all that is required of government outlays is timing of certain expenditures so that they bolster employment and purchasing power when the economy needs stimulus and taper off as it approaches full employment. In both cases, the form of action required for purposes of stabilization and the procedure for taking timely action can be agreed upon in advance.

The President's Recommendations

The President has recommended a three-part program for economic stabilization. Its enactment would be the most significant step forward in policy for economic stabilization since the Employment Act itself. These three measures parallel recommendations of the Commission on Money and Credit, a private group of leading citizens representing diverse economic interests and viewpoints.

Stand-by capital improvements authority. Under the first measure, the Congress would give the President stand-by authority to initiate at a time of rising unemployment up to $2 billion of public investments. More specifically, the program of accelerated capital improvements could be initiated by the President within two months after the seasonally adjusted unemployment rate (a) had risen in at least three out of four months (or in four
out of six months) and (b) had risen to a level at least one percentage point higher than its level four months (or six months) earlier. Before invoking this authority, the President would be required to make a finding that current and prospective economic developments require such action to achieve the objectives of the Employment Act.

Under the program, the President would be authorized to commit up to (1) $750 million for direct Federal expenditures, (2) $750 million for grants-in-aid to State and local governments, (3) $250 million in loans to such States and localities as would otherwise be unable to meet their share of project costs, and (4) a further $250 million to be distributed among the above three categories as he might deem appropriate. Once initiated, the program could be terminated at any time by the President.

The program is designed to permit the timely initiation and execution of capital improvement projects which are desirable in their own right. To insure that the projects are appropriately timed, several important safeguards are incorporated in the proposal. An expanded capital improvements program initiated by the President under this authority would automatically be terminated within 12 months after initiation, unless extended by the Congress. Once a program had been terminated, a new program under this authorization could not be initiated by the President for 6 months. With respect to grant-in-aid expenditures, the President would be required to prescribe rules to assure that assisted projects were of high priority, were a net addition to existing State and local expenditures, and were of the type which could be started quickly and carried speedily to conclusion. Under existing legislation, Federal advances are provided to aid State and local governments to plan projects which would meet these specifications.

To insure that the projects are desirable on their own merits, the proposal would limit direct Federal expenditures to projects and programs previously authorized by the Congress. Appropriate projects would include resource conservation (e.g., reforestation, reseeding of range lands, timber stand improvement) and various Federal public works, including construction, repair, or modernization of Federal buildings. Examples of projects for which State and local governments could receive grants are hospitals, airports, schools, waste treatment facilities, street repairs and improvements, water and sewer systems, and deferred maintenance and improvement of public buildings.

The unemployment criteria for triggering the accelerated capital expenditures program are rigorous enough to prevent untimely or premature activation, but not so restrictive as to delay the effects of the program until late in the recovery period. The criteria for initiation of the program would have been met in the early stages of each of the four postwar recessions. Furthermore, no false signals would have been given. Even if the criteria were to give a false signal in the future—for example
if unemployment were to rise because of a major strike—the President simply need not invoke the authority.

Table 6 shows the dates at which the unemployment criteria would first have been met in each recession of the past decade, the date of the previous peak, the date of the low point of the recession, and the date at which the economy subsequently returned to full employment. In every case, Presidential authority could have been invoked within four months after the previous cyclical peak and well before the trough of the recession. The first impact of orders, contracts, and expenditures under the program would have been felt within one or two months after the authority was invoked.

### Table 6.—Hypothetical timing of proposed capital improvements program in four postwar business cycles

<table>
<thead>
<tr>
<th>Business cycle peak</th>
<th>Unemployment criteria met</th>
<th>Business cycle trough</th>
<th>Subsequent achievement of full employment</th>
</tr>
</thead>
<tbody>
<tr>
<td>November 1948</td>
<td>March 1949</td>
<td>October 1949</td>
<td>October 1950</td>
</tr>
<tr>
<td>July 1953</td>
<td>November 1953</td>
<td>August 1954</td>
<td>July 1955</td>
</tr>
<tr>
<td>July 1957</td>
<td>November 1957</td>
<td>April 1958</td>
<td>(?)</td>
</tr>
<tr>
<td>May 1960</td>
<td>August 1960</td>
<td>February 1961</td>
<td>(?)</td>
</tr>
</tbody>
</table>

1 Criteria are met in any month in which the seasonally adjusted unemployment rate (a) had risen in at least three out of four months (or in four out of six months) and (b) had risen to a level at least one percentage point higher than its level four months (or six months) earlier. Program could be initiated within two months after criteria are met.

2 The date at which the economy returned to the neighborhood of a 4 percent unemployment rate.

3 Full employment has not been achieved since the beginning of the 1957 recession.

Source: Council of Economic Advisers.

The major impact of the program would occur when a stimulus is needed to arrest economic decline or support recovery. It would not be delayed until private demands are already pressing hard on the economy's capacity to produce. Table 6 indicates that a quick-starting, fast-moving capital expenditures program begun in the early stages of recession could have been terminated before the economy returned to full employment.

**Stand-by tax reduction authority.** The second recommendation is to establish a procedure for making quickly a temporary across-the-board reduction in the individual income tax rate. Such a reduction would be a speedy and powerful method of augmenting purchasing power throughout the Nation.

Specifically, the President would be given stand-by authority, subject to congressional veto, to reduce temporarily all individual income tax rates, in accordance with the following procedure:

1. Before proposing a temporary tax reduction, the President must make a finding that such action is required to meet the stabilization objectives of the Employment Act.
2. Upon such finding, the President would submit to Congress a proposed temporary uniform reduction in all individual income tax rates.
tax rates. The proposed temporary rates may not be more than 5 percentage points lower than the rates permanently established by the Congress.

(3) This change would take effect 30 days after submission, unless rejected by a joint resolution of the Congress.

(4) It would remain in effect for 6 months unless revised or renewed by the same process or extended by a joint resolution of the Congress.

(5) If the Congress were not in session, a Presidentially proposed tax adjustment would automatically take effect but would terminate 30 days after the Congress reconvened. Extension would require a new proposal to the Congress, which would be subject to congressional veto.

An across-the-board variation in the basic individual income tax rate can be a potent stabilization measure. At the current level of taxable income, a reduction of 1 percentage point in the tax schedule would add about $2 billion, at annual rates, to disposable personal income, and a full 5 point reduction would increase disposable income by $10 billion. Since nearly three-quarters of the individual income tax is collected through payroll deductions, the rate reduction would have an immediate effect upon incomes available to consumers. Payments of taxes on estimated declarations would also be reduced, raising still further the current flow of consumer incomes. Higher consumer incomes mean higher consumer spending. The resultant expansion in output and employment by the consumer goods industries and their suppliers would increase the incomes of those already employed and create jobs for many of the unemployed.

Policy to reverse recession or speed recovery often calls for a temporary boost in private purchasing power. Permanent reduction in tax rates could give the economy as strong, or stronger, a stimulus but at the possible sacrifice of tax revenues which would be most desirable after the economy returned to full employment. Private demands are weak in periods of recession and slack, but a large part of their weakness results from recession and slack themselves. Once full employment has been restored, with the help of the temporary tax reduction as well as other measures, private demands will be stronger simply because capacity operation is itself a powerful stimulus. At that time, the private economy no longer needs the fiscal stimulus which is appropriate to reverse a decline or support a recovery. In that case a return to permanent tax rates may be desirable in order to provide room in a non-inflationary full employment economy for defense outlays and other continuing government programs of high priority. Indeed, a Federal surplus, normally to be expected at full employment, will provide saving to finance private investments stimulated by capacity operations and prosperity profits. Under the proposal, a tax adjustment can be speedily invoked to
meet the temporary requirements of economic stabilization, without per-
manently sacrificing revenues needed at a later date.

Improvement of the unemployment compensation system. The third
major recommendation is to strengthen the Federal-State unemployment
compensation system. The proposed legislation will make the unemploy-
ment insurance system more effective in meeting its two objectives. Indi-
vidual workers will be more secure against the risks of unemployment. The
economy will be more secure against the risks of sharp declines in purchas-
ing power.

As pointed out in Part I of this chapter, unemployment benefits are now
generally smaller, relative to earnings, than the 50 percent envisaged when
the system was first inaugurated a generation ago. Furthermore, it has
been necessary during the last two recessions to enact temporary legislation
to extend the period of unemployment compensation for the large numbers
of workers who had exhausted their benefit rights. To insure that ex-
perienced workers who suffer long-term unemployment during periods of
prosperity will receive the same benefits as during recessions, the Administra-
tion has proposed a permanent Federal program under which the period
of unemployment compensation would be extended by as much as 13 weeks
for workers who have had at least three years’ experience in insured work.
The proposal also provides, when unemployment is widespread, a Federal
program extending the period of benefits for all insured workers, including
those who do not qualify for the permanent program of extended benefits
because they have had less than three years of experience in insured work.
This extension could be put into effect upon proclamation by the President
when insured unemployment has reached 5 percent and the num-
ber of benefit exhaustions in a three-month period has reached 1 percent
of insured employment. In these periods, regular benefits are exhausted
by large numbers of workers and particularly by workers who have only
limited experience in insured employment.

To raise the percentage of wages compensated by unemployment insur-
ance and to accomplish other needed reforms, the following recom-
mendations are made: (1) an additional three million workers should be
covered; (2) States should be required to meet higher standards with
respect to the amount of weekly benefits; (3) States which have experienced
heavy insured unemployment should receive reinsurance grants; (4) a State
may not deny compensation to claimants undergoing approved training.

Since the unemployment compensation system is an insurance program
designed to be self-financing, increased benefits must be matched by in-
creased contributions. The proposal would increase the taxable wage base
from $3,000 a year to $4,800 and make permanent the temporary increase
adopted in 1961, which raised the net Federal unemployment tax from
0.4 percent to 0.8 percent.
These three recommendations together constitute a far-reaching innovation in discretionary fiscal policy. At the same time, they are moderate proposals, carefully defining and limiting the authority which they confer. They will go a long way toward providing the flexibility in fiscal policy which is essential if the Nation is to make prosperity the rule and not the exception in its economic life. In the past 7 years the Nation has undergone three recessions. In the 4½ years since 1957, full employment has not once been attained. While some fluctuations in business and consumer spending will always occur, nothing in our free enterprise economy condemns us to repeat this recent experience. Prudent innovations in the tools of fiscal policy, and careful use of both new and old tools, can greatly improve the stability of our economy in the years ahead.

BUDGET POLICY, 1958–63

The Federal budget has influenced economic activity in recent years in two ways: through the workings of the built-in stabilizers, and through discretionary changes in the budget program. It is not easy to separate these two influences. In order to do so, it is necessary, first, to view Federal fiscal transactions in the same accounting framework used to describe the whole economy. The national income accounts budget is a way of measuring and classifying Federal transactions which accords with the national income and product accounts for the economy. Second, it is convenient to have a numerical measure of the expansionary or restrictive impact of a budget program on the economy. The full employment surplus is such a measure. This section discusses these two somewhat unfamiliar but highly useful tools and then applies them in an analysis of recent and prospective budget policies.

The National Income Accounts Budget

The effects of Federal receipts and expenditures on the income stream are most accurately represented when the budget is viewed in the framework of the national income accounts. These accounts present a consistent record and classification of the major flows of output and income for the entire economy, including the transactions of the Federal Government. There are three major differences between the Federal budget as it is conventionally presented (the so-called “administrative budget”) and the accounts of the Federal sector as they appear in the national income. The major differences between these two budgets, and between both of them and the consolidated cash budget, are schematically summarized in Table 7. There are other, less significant differences among the budgets, such as the treatment of intragovernmental transactions.

First, the national income accounts budget, like the consolidated cash budget, includes the transactions of the trust funds, which amount currently to about $25 billion per year and have a significant impact on the economy. Highway grants-in-aid, unemployment compensation payments, and social security benefits are examples of trust fund transactions. Because
TABLE 7.—Major differences among three concepts of the Federal budget

<table>
<thead>
<tr>
<th>Item</th>
<th>Budget concept</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Administrative Collections</td>
</tr>
<tr>
<td>Timing of receipts</td>
<td>Included</td>
</tr>
<tr>
<td>Treatment of net loans and other credit transactions</td>
<td>Excluded</td>
</tr>
<tr>
<td>Treatment of trust fund transactions</td>
<td>Excluded</td>
</tr>
</tbody>
</table>

Source: Council of Economic Advisers.

the traditional budget—or administrative budget—is primarily an instrument of management and control of those Federal activities which operate through regular congressional appropriations, it excludes the trust funds, which have their own legal sources of revenue.

Second, transactions between government and business are, so far as possible, recorded in the national income accounts budget when liabilities are incurred rather than when cash changes hands. This adjustment in timing affects both government purchases and taxes, shifting them to the point in time at which they are likely to have their principal impact on private spending decisions. The choice of an accrual, rather than a cash, basis for timing is particularly important for the highly volatile corporate income tax. Since these taxes are normally paid more than six months after the liabilities are incurred, payments of corporate income taxes, as recorded in the administrative budget, run substantially below accruals in a period of rising economic activity. For fiscal year 1962, this difference is estimated at about $3 billion.

Finally, unlike the administrative budget, the national income accounts budget omits government transactions in financial assets and already existing assets. The largest omission is the volume of loans extended by the Federal Government. This volume is estimated at $4 billion net of repayments in fiscal year 1962. While these loans have important effects on economic activity, they are properly viewed as an aspect, not of fiscal policy, but of monetary and credit policy, and are so discussed later in this chapter. Borrowers from the Federal Government, like borrowers from private financial institutions, acquire cash by incurring debts. They add thereby to their liquidity, but not directly to their incomes.

The Full Employment Surplus

As pointed out earlier in this chapter, the magnitude of the surplus or deficit in the budget depends both on the budget program and on the state of the economy. The budget program fixes both tax rates and expenditure programs. The revenues actually yielded by most taxes, and the actual expenditures under certain programs like unemployment compensation, vary automatically with economic activity. To interpret the economic significance of a given budget it is, therefore, essential to distinguish the
automatic changes in revenues and expenditures from the discretionary changes which occur when the Government varies tax rates or changes expenditure programs. The discussion that follows runs in terms of the national income accounts budget.

In Chart 6 this twofold aspect of fiscal policy is portrayed for the fiscal years 1960 and 1962. Since tax revenues and some expenditures depend on the level of economic activity, there is a whole range of possible surpluses and deficits associated with a given budget program. The particular surplus or deficit in fact realized will depend on the level of economic activity. On the horizontal scale, Chart 6 shows the ratio of actual GNP to the economy's potential, labeled the "utilization rate." On the vertical scale, the chart shows the Federal budget surplus or deficit as a percentage of potential GNP.

**CHART 6**

**Effect of Level of Economic Activity on Federal Surplus or Deficit**

---

1/ACTUAL GNP AS PERCENT OF POTENTIAL GNP.
SOURCE: COUNCIL OF ECONOMIC ADVISERS.
The line labeled "fiscal 1960 program" represents a calculation of the budget surplus or deficit which would have occurred at various levels of economic activity, given the Federal expenditure programs and the tax rates of that year. For the reasons explained earlier, the same budget program may yield a high surplus at full employment and a low surplus or a deficit at low levels of economic activity. The actual budget position in fiscal year 1960, a surplus of $2.2 billion or 0.4 percent of potential GNP, is shown at point A; this accompanied a level of GNP 5 percent below potential. Had full employment been achieved that year, however, the same basic budget program would have yielded a surplus of about $10 billion, or nearly 2 percent of gross national product (point F in the chart). The line labeled "1962 program" similarly shows the relationship between economic activity and the surplus or deficit, for the budget program of 1962; the expected deficit is shown at point B, and the full employment surplus at point G.

It is the height of the line in Chart 6 which reflects the basic budget program; the actual surplus or deficit depends both on the height of the program line and the level of economic activity. In other words, discretionary fiscal policy, by changing the level of Government expenditures or tax rates shifts the whole program line up or down. The automatic stabilizing effects of a given budget program are reflected in the chart by movements along a given line, accompanying changes in economic activity. One convenient method of comparing alternative budget programs, which separates automatic from discretionary changes in surplus and deficits, is to calculate the surplus or deficit of each alternative program at a fixed level of economic activity. As a convention, this calculation is made on the assumption of full employment. In Chart 6, the points F and G mark the full employment surplus in the budget programs of fiscal years 1960 and 1962, respectively. The statement, "the fiscal 1960 budget had a larger full employment surplus, as a fraction of potential GNP, than the 1962 budget" is a convenient shorthand summary of the fact that the 1962 budget line was below the 1960 line, yielding smaller surpluses or larger deficits at any comparable level of activity.

The full employment surplus rises through time if tax rates and expenditure programs remain unchanged. Because potential GNP grows, the volume of tax revenues yielded by a fully employed economy rises, when tax rates remain unchanged. Full employment revenues under existing tax laws are growing by about $6 billion a year. With unchanged discretionary expenditures, a budget line drawn on Chart 6 would shift upward each year by about 1 percent of potential GNP.

The full employment surplus is a measure of the restrictive or expansionary impact of a budget program on over-all demand. Generally speaking, one budget program is more expansionary than another if it has a smaller full employment surplus. One budget program might have the smaller full employment surplus because it embodies greater Federal purchases of goods and services, in relation to potential GNP. By the same
token, it leaves a smaller share of full employment output for private purchase. This means that full employment is easier to maintain under the budget program with the smaller surplus, because less private demand is required. It also means that inflation is more difficult to avoid, because there are fewer goods and services to meet private demand should it prove strong. Alternatively, one budget program might have a smaller full employment surplus than a second because it involves either lower tax rates or larger transfer payment programs. In that event, private after-tax incomes are larger at full employment for the first budget program than for the second. As a result, private demand would be stronger under the first program.

If the full employment surplus is too large, relative to the strength of private demand, economic activity falls short of potential. Accordingly, the budget surplus actually realized falls short of the full employment surplus; indeed, a deficit may occur. If the full employment surplus is too small, total demand exceeds the capacity of economy and causes inflation.

But whether a given full employment surplus is too large or too small depends on other government policies, as well as on economic circumstances affecting the general strength of private demand. If the full employment surplus is too large, more expansionary monetary and credit policies may strengthen private demand sufficiently to permit full employment to be realized. Changes in tax structure, stimulating demand while leaving the yield of the tax system unchanged, might have the same effect. Similarly, restrictive changes in other government policies can offset the expansionary influence of a low full employment surplus.

A mixture of policies involving (1) a budget program with a relatively high full employment surplus and (2) monetary ease and tax incentives stimulating enough private investment to maintain full employment, has favorable consequences for economic growth, discussed in Chapter 2.

The Budget in 1958–60

The analysis of the budget program in terms of the full employment surplus points to a probable major cause of the incomplete and short-lived nature of the 1958–60 expansion. The most restrictive fiscal program of recent years was the program of 1960. Its full employment surplus exceeded any from 1956 to date. Estimates of the full employment surplus by half years are shown in Chart 7. The full employment surplus declined sharply as a result of higher expenditures during the 1957–58 recession until it reached an estimated $3 billion in the second half of 1958. Thereafter, it rose gradually through most of 1959 but then increased sharply to about $12½ billion in 1960. Thus, whereas the Federal budget contributed to stability during the contraction phase of the cycle and during the first year of the expansion, it was altered abruptly in the direction of restraint late in 1959 at a time when high employment had not yet been achieved.
Federal Fiscal Activity in 1961–62

Immediately upon taking office, the new Administration moved vigorously to use the fiscal powers of the Federal Government to help bring about economic recovery. Federal procurement was accelerated by Presidential directive early in February, and tax refunds were also expedited. A listing of Administration stabilization policies during 1961 is provided in the Appendix to this chapter. Changes in transfer programs added about $2 billion to the combined total of transfer payments for fiscal years 1961 and 1962. The Veterans Administration advanced the payment of $150 million of veterans' life insurance dividends into the first quarter of calendar year 1961, and then made an extra dividend payment of $218 million at midyear. The Congress promptly adopted a number of measures requested by the President. A Temporary Extended Unemployment Compensation Act was adopted, providing for extension of exhausted benefits and giving the Administration time to develop a comprehensive program for permanent
improvement in unemployment compensation. Social security benefits were increased effective in August, and aid was extended to children dependent on unemployed persons. Transfer payments represent a major element of flexibility in Federal expenditures. While transfer programs—like any Federal outlays—ought to stand on their merits, the precise timing of worthwhile new programs properly depends on economic conditions. The objectives of economic stabilization in 1961 argued strongly for speeding the introduction of programs like improvements in social security, scheduled to be adopted later.

Other Federal outlays increased in 1961 to meet specific national needs. Federal grants to States and localities for urban renewal, area redevelopment, highways, and public assistance increased. Direct payments to farmers were increased as a result of participation in the feed grains program. The largest increases in expenditures came in the areas of defense and space exploration. These programs were expanded for reasons of national security, not for economic stabilization. However, stabilization objectives ruled against any increases in tax rates to finance these new expenditures.

During 1961, the estimated full employment surplus declined significantly, from an annual rate of $12½ billion in the second half of 1960 to $8½ billion in the second half of 1961. As shown in Chart 7, the actual surplus or deficit has been substantially different from its full employment counterpart. Since private incomes declined during late 1960 and into 1961, the actual budget position shifted from a surplus of $1 billion in the second half of 1960 to a deficit of $5 billion in the first half of 1961. Then as the economy began to recover, the deficit, in the national income accounts, shrank to $2 billion in the second half of the year. The rising deficit in the early part of 1961 was due both to a shift downward in its budget program line (as discretionary budget outlays were increased) and to a movement to the left along the new line (as private incomes and Federal tax receipts declined).

The Federal national income accounts budget appropriately showed its largest deficit early in 1961, when the economy was near the trough of recession. Since then, the deficit has been steadily declining in spite of rising expenditures, and a surplus is expected in the first half of 1962. The administrative and cash deficits show a different time pattern, with deficits rising in the 1962 fiscal year, primarily because tax collections lag behind tax liabilities.

The fiscal actions taken during the past year reflect the Administration's philosophy that the budget is a positive instrument for economic stabilization. According to the original January 1961 budget estimates, expenditures on national income-and-product account were expected to reach a level of $98 billion in fiscal year 1962. Present estimates, which incorporate all of the changes made by executive and legislative action, indicate that these expenditures will amount to more than $106 billion. This increase in
expenditures is itself responsible for a rise in the gross national product that can be estimated conservatively at $15 billion.

**Budget Policy for Fiscal 1963**

The balanced administrative budget proposed for fiscal year 1963 projects an increase over the current fiscal year of nearly $6 billion in Federal outlays on income-and-product account. Because of the $2 billion a year increase in social insurance taxes effective January 1, 1963, the full employment surplus rises in the first half of 1963. But it remains considerably below the level of 1960 (Chart 7). Fiscal policy will be less restrictive than it was in the late stages of the last recovery. The budgetary program, yielding a surplus on income-and-product account of $4.4 billion reflects the reasonable expectation that 4 percent unemployment will be reached by the end of the 1963 fiscal year. The feasibility of this objective and the outlook for the economy have been appraised in detail in Part I above. Obviously, the strength of private demand over the next 18 months cannot now be assessed with precision. Any plans covering the uncertain future are necessarily risky. A less expansionary budget with a larger full employment surplus would provide added assurance of price stability but only at the cost of increased dangers of an incomplete recovery. A more expansionary budget would, on the other hand, improve the outlook for maximum production and employment but increase the risks of rising prices.

The risks of an incomplete recovery, on the one hand, or of rising prices on the other, are fortunately reduced by the automatic stabilizing characteristics of the budget. If private demand proves excessively buoyant, the added revenues can be expected to enlarge the surplus in the budget, thereby moderating inflationary pressures. Conversely, any shortfall in private demand will likewise be partially countered by a shortfall in tax revenues. In addition, discretionary policy will remain flexible. First, monetary policy can be used flexibly. The Federal Reserve can attune its policies to the pattern of output, employment, and prices as it unfolds during the months ahead. Second, as the experience of 1961 demonstrated, the budget itself is a flexible tool which can be adjusted during the course of a fiscal year by varying the timing of outlays and by legislative action. Finally, the President's stabilization proposals described earlier in this chapter, would, if adopted, significantly strengthen the government's ability to act swiftly and energetically in meeting unforeseen economic developments.

**Monetary and Credit Policies and Economic Stability**

The second major instrument of the Government for economic stabilization is monetary and credit policy, interpreted in the broadest sense to encompass all governmental actions affecting the liquidity of the economy and the availability and cost of credit. Here the Federal Government has broad and inescapable responsibilities, stemming basically from the sovereign right of Congress "to coin money, regulate the value thereof."
Government's influence is exercised in several ways—principally through Federal Reserve control of the total volume of bank reserves, but also through Treasury management of the public debt and through the administration of a variety of government lending and credit guarantee programs. These powers can significantly affect the flow of funds into business investment, capital expenditures of State and local governments, residential construction, and purchases of consumer durable goods. Monetary and credit policies can be flexible, responding at short notice to changes in economic circumstances and prospects.

In an important sense, the private economy of the United States contains automatic or "built-in" monetary stabilizers. Unless the Government acts to make compensating changes in the monetary base, expansion of general economic activity, accompanied by increased demands for liquid balances and for investment funds, will tend to tighten interest rates and restrict the availability of credit. Similarly, a recession of business activity will normally lead to lower rates, easier terms, and less stringent rationing by lenders. Like fiscal stabilizers, the monetary stabilizers are often useful built-in defenses against recessions or against inflationary excesses of demand. But these defenses may not be strong enough. Being automatic stabilizers, they can only moderate unfavorable developments; they cannot prevent or reverse them. And at other times, unless the monetary authorities offset their effects, they can operate counter to basic policy objectives, braking expansions short of full employment. Discretionary policy is essential, sometimes to reinforce, sometimes to mitigate or overcome, the monetary consequences of short-run fluctuations of economic activity. In addition, discretionary policy must provide the base for expanding liquidity and credit in line with the growing production potential of the economy. For these reasons, the Federal Reserve System is continuously making and executing discretionary monetary policy.

The proper degree of general "tightness" or "easiness" of monetary policy, and the techniques by which the various governmental authorities can appropriately seek to achieve it, depend on the state of the domestic economy, on the fiscal policies of the Government, and on the international economic position. When the economy is in recession or beset by high unemployment and excess capacity, monetary policy should clearly be expansionary. How expansionary it should be depends very much upon the extent of the stimulus that the government budget is, and will be, giving to over-all demand. When demand is threatening to outrun the economy's production potential, monetary policy should be restrictive. How restrictive it should be depends, again, upon how much of the job of containing inflation is assumed by fiscal policy. There is, in principle, a variety of mixtures of fiscal and monetary policies which can accomplish a given stabilization objective. Choice among them depends upon other objectives and constraints. The relation of this choice to economic growth was noted above; the stabilization of demand at full employment levels by a budget
surplus compensated by an expansionary monetary policy is favorable to
growth. On the other hand, monetary policy may in some circumstances
be constrained by the balance of payments. If low interest rates encourage
foreign borrowing in the United States and a large outflow of funds seeking
higher yields abroad, monetary policy may have to be more restrictive
than domestic economic objectives alone would dictate. The first line
of defense is to try to adapt the techniques of monetary control, so that
policy can serve both masters at once. Even so, difficult decisions of balance
between conflicting objectives may sometimes be unavoidable.

*Monetary Policy and Debt Management*

At the beginning of 1960, monetary policy was restrictive and interest
rates were generally at postwar peaks. Despite bullish expectations about
the economy, interest rates soon began a slow decline that lasted seven or
eight months, aided by a gradual reversal of Federal Reserve policy
(Table 8) beginning in March and furthered by the recession starting in
May.

However, the Federal Reserve's anti-recession policy, for the first time
since the early 1930's, was constrained by a serious balance of payments
situation. Through its choice of expansionary monetary techniques, the
Federal Reserve sought to avoid adding to the already large outflow of short-
term capital. The 3-month Treasury bill rate did not fall below 2 percent.
Long-term interest rates declined from their peaks but remained con-
siderably above their previous cyclical troughs (Chart 8). This was a mat-
ter of serious concern because of the importance of long-term interest rates
for business capital investment, residential construction, and State and local
governmental spending on public facilities. And neither the money supply
nor long-term private financing responded as promptly as in previous
periods of monetary ease.

The new Administration faced in January 1961 both economic recession
and a crisis of confidence in the dollar that threatened to limit sharply the
use of expansionary monetary policy for economic recovery and growth.
The Administration's forthright attack on the balance of payments problem
restored confidence in the dollar. The resulting reduction in the discount
on the dollar in the forward markets for foreign exchange eliminated any
significant advantage in sending short-term funds abroad and helped to
make it possible for monetary policy to support domestic expansion.

The ability of monetary policy to support economic expansion at home
without stimulating outflows of short-term funds was simultaneously en-
hanced by new Federal Reserve open market techniques and by Treasury
debt management policies. In his Economic Message of February 2, the
President had emphasized the importance of "increasing the flow of credit
into the capital markets at declining long-term rates of interest to promote
domestic recovery," while "checking declines in the short-term rates that
directly affect the balance of payments." The Federal Reserve sold short-
CHART 8

Interest Rates in Three Business Cycles

NOTE: DATA ARE PLOTTED FROM CYCLICAL PEAK (P) TO 10 MONTHS AFTER CYCLICAL TROUGH (T).

SOURCES: MOODY'S INVESTORS SERVICE, FEDERAL HOUSING ADMINISTRATION, AND BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.
TABLE 8.—Principal Federal Reserve monetary actions, 1960–61

<table>
<thead>
<tr>
<th>Date</th>
<th>Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960: March</td>
<td>Federal Reserve open market operations modified so as to exert moderately less restraint on bank reserve positions than in earlier months. Effect was to allow reduction in net borrowed reserves.</td>
</tr>
<tr>
<td>May</td>
<td>Open market operations modified to provide reserves for moderate expansion of bank credit and money supply.</td>
</tr>
<tr>
<td>June</td>
<td>Discount rates reduced from 4 percent to 3½ percent.</td>
</tr>
<tr>
<td>July</td>
<td>Margin requirements reduced from 90 percent to 70 percent.</td>
</tr>
<tr>
<td>August</td>
<td>Authorized member banks to count about $500 million of vault cash as required reserves. Reduced reserve requirements against demand deposits at central reserve city banks from 15 percent to 17½ percent, effective September 1, releasing about $125 million of reserves.</td>
</tr>
<tr>
<td>August–September</td>
<td>Discount rates reduced from 3½ percent to 3 percent. Open market operations modified to suggest a positive attitude toward increasing the availability of reserves.</td>
</tr>
<tr>
<td>October</td>
<td>Purchased short-term U.S. Government securities other than Treasury bills for first time since 1958 to minimize downward pressure on 3-month bill rate, thus keeping bill rate more competitive internationally.</td>
</tr>
<tr>
<td>November–December</td>
<td>Authorized member banks to count all vault cash in meeting reserve requirements, reduced reserve requirements against demand deposits at central reserve city banks from 17½ percent to 16½ percent, raised requirements for country banks from 11 percent to 12 percent. Net effect of actions was to release about $1.3 billion of reserves.</td>
</tr>
<tr>
<td>1961: January–early February</td>
<td>Open market operations aimed at maintaining ease in member bank reserve positions, with seasonal increases in reserve funds about offset by gold outflow and other factors draining reserves.</td>
</tr>
<tr>
<td>February–December</td>
<td>On February 20, began providing reserves through purchases of longer-term U.S. Government securities, while selling short-term Government securities at times. Expansion in money supply became more rapid later in the year, with monetary ease being maintained throughout the year.</td>
</tr>
<tr>
<td>December</td>
<td>Board of Governors announced increase in maximum rates payable on savings and other time deposits, effective January 1, 1962. The action was taken to promote competition for savings and to encourage retention of foreign funds by member banks and thus moderate pressures on this country’s balance of payments.</td>
</tr>
</tbody>
</table>

1 Treasury also purchased very long-term U.S. Government securities for Government investment accounts. In his Economic Message of February 2, President Kennedy had announced that the Federal Reserve and Treasury were developing techniques to help keep long-term rates down while holding short-term rates at internationally competitive levels.

Source: Council of Economic Advisers.

term securities, while the Treasury further increased the outstanding supply through new cash offerings. On February 20, the Federal Reserve announced a new policy of providing bank reserves through purchases of U.S. Government securities of longer maturities, particularly in the 3- to 6-year range. Its purchases of U.S. Government securities of maturity of more than 1 year amounted to $2.6 billion in 1961. The Treasury, in administering the investment portfolios of various government investment and trust accounts, made substantial purchases of securities of maturities of more than 10 years. Aided by these actions, long-term bond rates declined until May and rose only moderately thereafter in the face of an economic recovery that had begun in February.

Through substantial net purchases of U.S. Government securities, the Federal Reserve increased member bank reserves in 1961 by about $1 billion. As a result banks steadily expanded their loans and investments; the
increase during the year was considerably more than in 1960 and about the same as in the peacetime record year, 1958. Persistently expecting an up-trend in market interest rates, banks maintained lending rates in the face of generally weak demands for short-term loans, and added $6 billion to their holdings of U.S. Government securities. However, the expansion of bank holdings of Government securities made more funds available on the open market. And the high level of bank holdings of short-term government securities, combined with abundant free reserves, put pressure on banks to expand business loans and to lend directly in the capital markets. As monetary ease persisted and expectations of rising interest rates subsided, banks stepped up purchases of State and local securities and expanded mortgage lending. The 7 percent increase in total bank deposits and currency during 1961 fell just short of the peacetime record, although public preference for time deposits held the increase in the money supply (demand deposits and currency) to about 3 percent.

The liquidity of the economy was also increased by changes in the composition and level of the Federal debt held outside the Federal Reserve and the Treasury. Open market and debt management operations added substantially to the supply of U.S. Government securities maturing within 1 year. The volume of less liquid securities, maturing within 1 to 5 years, declined. The volume of outstanding securities greater than 5 years in maturity remained the same. The average maturity of that part of the debt held outside the Federal Reserve and U.S. Government investment accounts declined from 58 months to 56 months. The average maturity of the total marketable public debt changed little in 1961. Two advance refundings, designed to have a minimal impact on over-all liquidity, helped to offset shortening as a result of mere passage of time.

Federal Reserve and Treasury debt operations provided the basic liquidity necessary for economic expansion. Individuals, in addition to increasing their deposits in commercial banks, stepped up their accumulation of claims on such financial intermediaries as savings and loan associations, mutual savings banks, and life insurance companies, while cutting down their purchases of securities on the open market. This behavior was in part a response to the high level of interest and dividend rates paid by financial intermediaries relative to yields of high-grade open market securities. Liquid assets held by the public—defined to include the money supply, savings deposits and shares, U.S. Savings bonds, and short-term U.S. Government securities—grew by 7 percent in 1961, paralleling the rise in GNP. Financial intermediaries used the funds which flowed into them from the public to extend credit by acquiring mortgages, bonds, and other loans and securities. In this way, their operations both increased the liquidity of individuals and made more long-term credit available.

The total volume of mortgage, corporate, and State and local long-term financing rose sharply to what appears to be a new record (Table 9).
### Table 9.—Funds raised in money and capital markets, by type of instrument, 1957–61

[Billions of dollars]

<table>
<thead>
<tr>
<th>Type of instrument</th>
<th>1957</th>
<th>1958</th>
<th>1959</th>
<th>1960</th>
<th>1961</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>36.6</td>
<td>46.2</td>
<td>62.1</td>
<td>39.5</td>
<td>50.1</td>
</tr>
<tr>
<td>Federal obligations ¹</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Short-term</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term ²</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private</td>
<td>35.6</td>
<td>37.3</td>
<td>49.9</td>
<td>41.6</td>
<td>43.5</td>
</tr>
<tr>
<td>Direct marketable issues maturing in one year or less. ³</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State and local securities</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporate securities</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other ⁴</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgages</td>
<td>28.2</td>
<td>32.9</td>
<td>33.0</td>
<td>28.1</td>
<td>33.7</td>
</tr>
</tbody>
</table>
| Corporations borrowed unusually heavily in long-term capital markets but added in the aggregate almost as much to their financial assets, of a generally liquid character, as to their financial liabilities. Monetary ease, in facilitating this financing, laid the financial groundwork for expanded corporate capital spending in the future. Because of the expansion in liquidity and in the supply of credit through financial institutions, interest rates were relatively stable during 1961, in sharp contrast to the previous upswing (Chart 8). The rate of 3-month Treasury bills fluctuated within the narrow range of 2 1/4 and 2 1/2 percent during most of the year, rising somewhat above this range toward the close. Most long-term rates declined through May and thereafter increased by only a small amount. Rates on home mortgages, which are more sticky than most other rates, continued to fall until midyear, and then remained fairly stable. Thus, 1961 has demonstrated that interest rates do not have to rise sharply in cyclical recoveries. Their movement is not governed by immutable natural law. It depends upon all economic circumstances and governmental policies affecting the supply of funds and the demand for them.

The behavior of interest rates during the year may also have signaled the ending of the upward trend in rates from the low levels at which they were pegged prior to the Treasury-Federal Reserve Accord of 1951. While this trend was in part an adjustment to the profitability of investment in capital goods, it also reflected the spread of inflationary expectations. Recent stability in industrial and consumer prices may, however, diminish in-
flationary psychology, so that inflation premiums would gradually be shaken out of the interest rate structure.

The climate for equity financing was also favorable during 1961. Common stock prices rose by about 25 percent, anticipating in part a recovery of corporate profits, and the average dividend yield on stocks fell below 3 percent.

**Federal Credit Programs**

The Administration sought to make credit readily available at liberal terms through programs of Federal lending and Federal insurance and guarantee of private lending. Important steps were taken to stimulate housing construction. Early in the year, the Federal Housing Administration (FHA) reduced the maximum permissible rate on insured mortgages in two steps, from 5 3/4 to 5 1/4 percent. The Federal National Mortgage Association (FNMA) supported these reductions by its secondary market operations in mortgages, raising both its purchase and selling prices repeatedly. Up to midyear, sales of mortgages by FNMA exceeded purchases, but after midyear its operations added to the supply of funds available for mortgages. The Federal Home Loan Bank Board and the regional Banks liberalized regulations and reduced interest rates on advances in order to stimulate mortgage lending by savings and loan associations.

For the longer run, the Housing Act of 1961 expanded or liberalized many existing credit programs and initiated new ones. A new FHA insurance program was set up for middle-income housing, with FNMA also prepared to purchase these mortgages under its special assistance programs. Maturities up to 35 years, in some cases up to 40 years, were authorized for FHA-insured mortgages and insurable loan-to-value ratios were increased. A new FHA program for insurance of long-term home improvement loans was instituted. FNMA made the new home improvement loans eligible for purchase under its secondary market operations, and, when used to finance rehabilitation of homes in urban renewal areas, the new loans are eligible for purchase by FNMA under its special assistance program. FNMA also was authorized to make short-term loans secured by federally underwritten mortgages. Funds were provided for loans for public facilities, college housing, farm housing, housing for the elderly, and FNMA special assistance. The capital grant authority for urban renewal was increased by $2 billion.

Other Federal credit programs contributed to making credit more generally available at liberal terms in 1961. In particular, the Small Business Administration reduced the interest rate on loans made in areas of substantial unemployment and instituted a simplified program to expand bank participation in small business loans.

Federal credit programs will support economic expansion during the coming fiscal year. New commitments are expected to rise to record levels. Direct loans and mortgage purchases (including trust fund purchases) will
approach $9 billion, $3 billion more than anticipated collections on outstanding loans. New commitments to guarantee or insure private loans will for the first time reach $20 billion.

 Monetary Expansion and Recovery

As the economy advances toward full employment, it will need more liquidity. Throughout the postwar period, and particularly in the three previous economic recoveries, the growth in liquidity has fallen considerably short of the growth in GNP. The economy had to work off the excess liquidity inherited from the war, interest rates were generally rising, and expectations of higher prices were spreading. These factors worked to reduce the liquidity requirements of the economy relative to GNP. And the growth in nonmonetary liquid assets diminished even more the needed growth in the money supply (bank deposits and currency). Business firms, government units, and individuals learned, to their advantage, how to minimize holdings of cash.

For each 1 percent rise in GNP in the three past economic recoveries, commercial bank deposits and currency increased by only about one-third of 1 percent, while liquid assets, more broadly measured, increased by about two-fifths to three-fifths of 1 percent. If these relationships should hold in the current economic recovery, and if gross national product rises to full employment levels by the middle of 1963—an increase of more than 20 percent from the trough in the first quarter of 1961—commercial bank deposits and currency would grow over the same period by 7–8 percent and liquid assets by 11–12 percent.

In the current recovery, however, the factors that served to limit liquidity requirements in the earlier recoveries may well be less important. In particular, interest rates may appropriately be more stable, for reasons already explained. Thus, these estimates of needed liquidity are probably conservative. The appropriate expansion of liquidity will depend upon the strength of private demands, on the tightness of fiscal policy, and on the balance of payments position.

 Improving the Mobility of Resources

Maximum employment and production depend not only on the success of stabilization policy in maintaining demand at appropriate levels but also on the mobility of labor and other productive resources in response to changes in demand and cost. If frictional and structural unemployment can be diminished, demand can be pressed further before encountering bottlenecks and price increases. Thus, measures to improve the mobility of resources enable stabilization policy to aim at, and to attain, higher levels of employment and production. Such measures are a basic part of the Administration’s economic program.
Labor Market Policies

Changes in technology and tastes are constantly altering the pattern of demand for labor in our economy. New industries appear and expand while old ones decline; job opportunities multiply in one region and disappear in another; new skills are required as old ones become obsolete. The more rapidly an economy grows and changes, the greater the flux in its labor markets.

A high level of over-all demand is a prerequisite for the efficient allocation of labor resources in a dynamic economy. It furnishes the most important single incentive for economically desirable labor mobility—the magnetic attraction of available job openings. However, a high level of demand will not by itself ensure the best possible degree of occupational, industrial, and geographic labor mobility, for it will not eliminate some important impediments to the desirable response of labor to job opportunities. Certain features of seniority, pension, and other benefit rights may serve to hold labor in industries and areas experiencing declining demand. Lack of knowledge of job openings and lack of the skills required to fill them constitute important barriers to labor mobility, and the high cost of moving is an insurmountable obstacle to the migration of many low-income families to areas of expanding employment. It is in the best interest of the economy, as well as of the individuals involved, that these impediments be reduced and that every wage earner be in a position to select the most favorable alternative from the widest possible range of employment opportunities.

Employment exchange. Letting employers know about available workers and telling workers about available jobs are difficult administrative and technical problems in a labor market as complex as ours. Yet doing this well can significantly reduce the number and size of labor shortages and help eliminate pockets of unemployment and underemployment.

A major effort has begun to improve the United States Employment Service so that it can do a better job in matching job vacancies with people. The staff has been substantially expanded, particularly in the metropolitan areas where most workers and jobs are concentrated. This staff will need, most importantly, to emphasize improvement in the quality of its counseling and placement work. The flow of information about jobs should be made nationwide through more extensive exchanges of job information among the State agencies. Also, since the performance of the important labor exchange function should not suffer from the tremendous administrative problems of administering unemployment compensation, these two activities should be separated where the volume of work permits.

As the United States Employment Service succeeds in improving its services, more people will use it. The larger the number of employers and workers using the Employment Service, the more complete will be the knowledge of the labor market available to each of them. A greatly
strengthened United States Employment Service will facilitate an expanded rate of economic growth and contribute to the effectiveness of such specific government programs as Area Redevelopment, Rural Redevelopment, and the proposed programs for Trade Assistance and Manpower Development and Training.

Training. The economic need for facilitating labor mobility through education and training programs is evidenced by the simultaneous existence of very low unemployment rates in various skilled, technical and professional occupations and relatively high unemployment among the less skilled groups. Programs for education and training should be directed particularly toward new entrants into the labor force and the training of adults for positions of increased productivity and income. Racial discrimination in training, as well as in hiring, must be eliminated. It is wrong— that is reason enough—and it is also an enormous waste of human talent.

The Administration is proposing a program to provide useful employment and training for young people through three pilot programs financed in whole or in part by the Federal Government. These programs provide for on-the-job training, public service employment and training, and employment, training, and educational opportunities through service in a Youth Conservation Corps. Special training programs for young people are contemplated; such programs are urgently needed in urban slum areas. Some of these programs for the training of youth should help, directly and indirectly, to stimulate and guide the flow of migration from the farm; in April 1960, 43.8 percent of the entire farm population and 59.0 percent of the nonwhite farm population were under age 20.

Lack of education certainly does not imply lack of aptitude, and widened educational opportunities enable individuals to improve their employment opportunities as well as the quality of their lives. The Administration's program for aid to States and educational institutions in extending and improving adult literacy programs is an important step toward reducing structural unemployment.

The Administration's key proposal for manpower development and training provides for the establishment of programs for selection, placement, and on-the-job training, and for improvement of State training facilities. Although intended primarily for the unemployed and underemployed, these programs would also be open to other qualified persons desiring to improve their skills or to acquire new skills.

Compensation for workers participating in a training program is essential. At present, many individuals are confronted with the hard choice between compensation without training and training without compensation; the necessity for this choice should be eliminated. Unemployed workers in most States are still disqualified from receiving unemployment insurance benefits if they participate in education and training programs.
Moreover, workers receiving benefits are required to be continuously available for job placement. Compensation for training would make it financially possible for an unemployed individual to complete a full course of training or retraining. Under the proposed program, allowances would be provided for certain trainees not receiving unemployment compensation benefits. Thus a large part of the cost of trainee compensation under the program would be offset by reductions in unemployment compensation payments and various other public assistance expenditures.

A major feature of the proposal is the provision for government studies on a national and local basis to determine the future requirements of the economy for various occupations and skills, to anticipate prospective manpower shortages, and to assure that workers are trained for occupations where opportunities will exist.

Resource Use in Agriculture

The agricultural population has long been a major source of manpower for U.S. industry. Many more children are born and raised on farms than will be needed to produce the Nation's food and fiber. They must be educated, trained, and guided to nonagricultural employment. Many adults now earn substandard incomes in farming. They are not in a technical sense structurally unemployed, but their distress is nevertheless a symptom of structural maladjustment. Programs of the kind just discussed—to facilitate labor mobility and training—can and should help many of these individuals to find new employment.

During the first two decades of this century, there was serious question whether agriculture could, with the closing of the land frontier, continue to meet the food and fiber demands of a growing national economy. The rate of growth in farm output was declining, and food and fiber prices were rising relative to other wholesale prices. The resulting public concern led to (1) increased emphasis on conservation and resource investment and (2) increased allocation of public funds for research and education designed to speed progress in agricultural technology.

By the mid-1920's, agricultural productivity was rising and farm employment declining. The full implications of rapid technological progress in agriculture were, however, obscured by the depression and by the Second World War and the Korean conflict. During the depression, the catastrophic decline in demand for farm products was the compelling problem, and policy was directed to protecting farm prices and incomes from its consequences. During the war and the Korean conflict, government programs were designed to encourage increases in output and to protect farmers from the effects of price reductions when emergency demands disappeared.

During the 1950's, the full effects of the programs set in motion early in the century began to be felt. The demand for farm output rose only slightly
faster than the population. Rapid gains in productivity put farm prices and incomes under increasing downward pressure. Farm programs designed for depression and war were continued, in order to hold at least part of the social gains from increasing agricultural productivity within the agricultural sector. Farmers also responded by leaving agriculture at the most rapid rate in history. Use of labor declined by almost one-third while output increased by more than one-fourth between 1950 and 1961.

By 1960, it was clear that agriculture’s relationship to the general economy had undergone a fundamental change in several respects. Agriculture can, without question, meet any foreseeable demands for food and fiber placed upon it. In 1910, it required 13.6 million farm workers to feed a Nation of 92.4 million people. By 1960, the population had increased to 180.7 million and farm employment had fallen to 7.1 million. The effects of fluctuations in national economic activity on the demand for farm output have been damped by built-in floors under consumer spending and by continuation of the emergency farm programs. Nevertheless, the stability and growth of the national economy are still of great importance to the farm population. Failure to maintain full employment limits the ability of industry to absorb farm workers displaced by advancing technology. During periods of peak economic activity, migration has been above 5 percent of the farm population. During recessions in the last decade, the migration rate out of agriculture has fallen considerably. Thus the problem of agricultural labor mobility is very largely a question of the availability of nonagricultural job opportunities. If job opportunities are available, the general manpower policies discussed above can facilitate the necessary migration and ease the human problems of adjustment.

Caught between the pressures of a slowly rising demand for farm products, rising productivity in agriculture, and limitations on nonfarm employment opportunities, total farm income and farm income per capita or per farm family have lagged behind incomes in the rest of the economy. The commodity programs have protected farm incomes from even greater declines, but at considerable budgetary expense and at some cost in delaying adjustment of patterns of resource use in agriculture. In 1961, farm incomes were increased and a significant start was made toward reduction of costs of surplus accumulation, storage, and disposal.

Objectives of agricultural policy as it develops in the future should encompass both (1) continuation of agriculture’s historic role as a major contributor to national economic growth and (2) equitable distribution of gains in agricultural productivity between farmers and consumers. Achievement of these two objectives will require continued rapid transfers of labor from the farm to the nonfarm sector and reduction in resources devoted to the production, storage, and disposition of surplus production.
Program for Economic Recovery and Growth

When the new Administration took office on January 20, 1961, it moved with speed and vigor to deal with the recession that had begun in May 1960. At his press conference of February 1, the President announced a series of administrative actions. He followed this with a comprehensive "Program to Restore Momentum to the American Economy," delivered before the Congress on February 2. Legislative requests, some of them directed toward the immediate situation, others toward future recovery and growth, were laid before the Congress in this speech and in a series of messages during the year.

The following is a list of the actions taken during 1961 to foster economic recovery and growth. Included also are measures (other than defense and foreign aid) which, though primarily directed to other purposes, contributed significantly to growth.

A. Executive and Administrative Actions

1. Accelerated Procurement and Construction

The President directed Federal agencies to accelerate procurement and construction planned for the rest of fiscal year 1961 under existing funds.

2. Post Office Construction

It was announced that post office construction, originally scheduled for implementation over 18 months, would be compressed into 10 months (March to the end of the calendar year). Although changes were made in this directive before the end of the calendar year, there was a substantial acceleration during the first half of 1961 in the provision of new offices. Projects for post offices were concentrated in areas of high unemployment.

3. Federal-Aid Highways, School and Other Construction

On February 2, the President made available $718 million of Federal-aid highway funds scheduled for release in the fourth quarter of fiscal 1961. Quarterly apportionments for the first and second quarters of fiscal 1962 were also released ahead of schedule, in May and August. On February 16, the President urged State Governors to speed the spending of $1.1 billion in Federal aid for highways, schools, hospitals, and waste treatment facilities.

4. Accelerated Tax Refunds

Taxpayers who were eligible for refunds were requested to file returns early to speed refund payments. In the first three months of 1961, individual income tax refunds totaled about $2.1 billion, 31 percent more than in 1960.
5. **Veterans Life Insurance Dividends**

On February 1, the President announced that he had directed the Veterans Administration to advance the payment of veterans life insurance dividends. The total payable, $258 million, over the entire calendar year was made available in the first quarter. In addition, a special dividend payment of $218 million was made in late June and in July.

6. **Price Supports and Farm Storage Payments**

Price supports were raised on corn, cotton, butterfat and milk, soybeans, and most other price-supported commodities for the 1961 crop year.

On February 8, the President directed the Department of Agriculture to speed payments to farmers for storage of crops under price support loans. The payments, advanced to early March, amounted to about $25 million.

7. **Food Distribution**

In his first executive order, the President, on January 21, directed the Secretary of Agriculture to expand the free food distribution program for needy families in areas of chronic unemployment. On January 24, the Secretary of Agriculture announced that, through additional purchases of protein foods, the Government would increase the variety of surplus foods being distributed. As a result of these actions, the annual rate of distribution was raised from about $60 million to more than $200 million.

8. **Food Stamp Program**

On February 2, the President announced the establishment of six area projects for operation of a pilot “food stamp” distribution program. This was subsequently expanded to eight areas.

9. **Farm Loans**

On February 8, the Department of Agriculture announced that, pursuant to a White House directive, it was making available an additional $50 million for housing loans to low-income farmers. On February 13, the Department announced that the Farmers Home Administration would release an additional $35 million for operating loans for farmers. Lending activity of the Farmers Home Administration for rural area development was accelerated.

10. **Rural Electrification Administration**

During the year, the Rural Electrification Administration intensified its activity in the field of rural area development.

11. **Monetary Policy and Debt Management**

As the President announced in his February 2 message, the Federal Reserve and the Treasury Department worked “to further the complementary effectiveness of debt management and monetary policy.” During the year, their policies were directed toward fostering domestic economic recovery by providing the base for needed bank credit and
monetary expansion and by encouraging the flow of savings and credit into long-term investment channels. The Federal Reserve provided bank reserves through purchases of securities of more than 1 year. The Treasury Department has been buying long-term U.S. Government securities for the trust fund accounts. At the same time, both monetary and debt management policies countered downward pressure on short-term rates, with a view to checking the outflow of funds from this country to money markets abroad.

12. Housing Actions

On February 1, the President announced a speeding up of the initiation of projects already approved (including the commitment of available college housing funds ahead of schedule).

On February 2, the maximum permissible interest rate on insured home loans of the Federal Housing Administration (FHA) was reduced from 5¾ percent to 5½ percent, and on May 29 to 5¼ percent.

The Community Facilities Administration reduced rates on new loans and broadened the program to include certain communities and projects previously excluded.

Purchase and sales prices for federally underwritten mortgages under Federal National Mortgage Association (FNMA) secondary market operations were raised in a series of steps. After the middle of 1961, purchases of mortgages by FNMA under secondary market operations exceeded sales.

The Federal Home Loan Bank Board liberalized terms under which Federal savings and loan associations can make mortgage loans; broadened the powers of insured associations to engage in participation loans; allowed member associations to borrow an amount up to 17½ percent of withdrawable accounts from Federal Home Loan Banks, in contrast to the former 12½ percent (this action was taken in two steps); caused Federal Home Loan Banks to reduce interest rates on advances to members; and instituted a new program of intermediate advances by Federal Home Loan Banks.

On February 2, the Urban Renewal Administration requested local public agencies to accelerate urban renewal activities.

On July 17, FHA eliminated the continuing service charge formerly permitted for home mortgages of $9,000 or less.

13. Small Business Administration Loans

On April 5, the Small Business Administration (SBA) announced a decrease from 5½ percent to 4 percent in the interest rate on loans to small businesses in areas of substantial unemployment, and a liberalization of size standards. The Agency also reduced from 5–5½ percent to 4 percent the interest rate on loans to State and local development companies in such areas. In August, it instituted a simplified bank loan participation plan
designed to achieve expanded commercial bank participation in small business loans.

14. Government Procurement in Areas of Substantial Unemployment

On February 2, the President announced that he was directing the Secretary of Defense, Secretary of Labor, and the General Services Administration to take steps to improve the mechanism for channeling Federal contracts to firms both in areas of substantial unemployment and in areas of substantial and persistent unemployment. Accordingly, the Federal Procurement Regulations have been amended (1) to provide procedures for the setting aside of appropriate procurements for award to firms which will perform a substantial proportion of the contracts in areas of substantial unemployment and areas of substantial and persistent unemployment, (2) to assure that concerns in such areas are afforded an equitable opportunity to compete for subcontracts under government prime contracts, and (3) to clarify and strengthen the preference for firms in such areas in procurements where equal low bids are received. Similar instructions have been issued in the Armed Services Procurement Regulation.

15. United States Employment Service (USES)

On February 2, the President directed the Secretary of Labor to expand and improve services to jobless applicants registered with the USES. Placement services, especially in metropolitan areas, have been realigned to meet the needs of workers and employers in all occupations. The Bureau of Employment Security and affiliated State agencies have increased program emphasis on job development for the unemployed, and testing, counseling, and placement activities for young people out of school and out of work.

16. Manpower Retraining

In anticipation of passage of the proposed manpower development and training act, the Secretary of Labor on November 27 requested all States to develop plans for immediate implementation of the law. In addition, the Department of Labor and the Department of Health, Education, and Welfare have coordinated plans for effectively carrying out their responsibilities under the act.

17. Export-Import Bank

The Export-Import Bank announced two new programs which make available export credit guarantees, insurance and financing for semifinished and consumer durable goods, and export credit insurance for consumer goods. The first of these makes available export credit insurance, covering both political and credit risks on short-term and medium-term credit sales, which will be issued through a private association of insurance companies. The second program consists of guarantees issued to financial institutions and Bank participation with financial institutions which finance exporters' medium-term credit sales on a nonrecourse basis. Both programs are de-
signed to enable the exporter to apply for assistance directly to his local commercial bank or insurance broker.

B. LEGISLATIVE RECOMMENDATIONS AND ACTIONS

1. Temporary Extended Unemployment Compensation

The President requested the Congress to increase temporarily the period during which unemployment insurance benefits might be paid. The Congress enacted this proposal. The legislation establishes, on a self-supporting basis, a temporary program of extended unemployment compensation to persons who have exhausted their benefits under State and Federal laws. It provides for agreements with States to pay temporary extended unemployment benefits, for any worker who exhausts his State benefits between June 30, 1960 and March 31, 1962, equal to 50 percent of the amount received in State unemployment benefits or 13 times his weekly benefit amount. The increases in benefits are being financed by an increase of 0.4 percent in the unemployment tax rate for the calendar years 1962 and 1963.

In addition, the Congress authorized a temporary self-supporting program of extended railroad unemployment insurance to workers who have exhausted normal benefits under the Railroad Unemployment Insurance Act.

2. Unemployment Compensation

The President, on June 13, proposed major changes in the Federal-State unemployment compensation system. The Administration bill, introduced in the First Session of the 87th Congress, would extend the scope of the system by increasing coverage to include over three million more workers; increase benefits so that a great majority of eligible claimants would receive a weekly benefit equal to at least one-half of their average weekly wage; establish a permanent Federal program of additional compensation for unemployed workers who have exhausted their regular benefits; and improve the financing of the program by increasing the wage base on which the unemployment tax is based from $3,000 to $4,800.

In addition, the measure includes equalization grants to States with high unemployment costs, and a provision precluding denial of unemployment compensation to claimants who are attending approved training or retraining courses.

The Congress took no action on the Administration bill in 1961.

3. Aid to Dependent Children

The Congress was requested to extend the program of aid to dependent children by providing benefits to children who are needy because of the unemployment of their parents. A bill was passed by the Congress and signed by the President on May 8. It is estimated that expenditures of about $100 million in fiscal 1962 are being made under this program.
4. Social Security Liberalization

The President proposed legislation to improve the old age, survivors, and disability insurance and public assistance programs. Such legislation was passed by the Congress and approved by the President on June 30 to provide, among other things, increased minimum social security benefits, an earlier retirement age for men, and increased benefits for widows. To meet the increased benefit costs the Federal Insurance Contribution Act taxes were increased, effective January 1, 1962, by one-eighth of 1 percent each on employers and employees.

5. Manpower Retraining

The President proposed a manpower development and training program, providing for counseling, training, relocation assistance, and vocational education. The Administration's bill provides for retraining unemployed persons who cannot reasonably be expected to secure full-time employment without retraining and for upgrading the skills of other members of the work force. It also provides for continuing review and assessment of the Nation's manpower requirements, for appropriate methods of testing, counseling, and selecting workers for training, for determining the skills in which they should be trained, for referral of workers for training, for placement services after completion of training, and for financial assistance during the training period for those unemployed workers who cannot undertake a training program without it.

The Senate approved a manpower retraining bill, and a bill was reported out by the House Education and Labor Committee. The House Rules Committee postponed giving a rule for debate on the bill until 1962.

6. Youth Employment Opportunities

The President recommended the enactment of a Youth Employment Opportunities bill. The proposal includes on-the-job training programs conducted in cooperation with both private and public groups, public service employment programs established in cooperation with State and local public and nonprofit agencies, and a Youth Conservation Corps which would perform conservation and related work pursuant to agreements with State and Federal conservation agencies.

Both Senate and House Committees reported out bills on the subject in 1961, but no further action was taken.

7. Minimum Wage

The President signed the Fair Labor Standards Act Amendments on May 5, extending coverage to approximately 3.6 million additional workers and increasing the minimum wage to $1.25 an hour over a period of time. The amendments represent the first Congressional action on extension of coverage since the Act was passed in 1938.

8. Area Redevelopment

The Administration proposal to aid areas with substantial and persistent unemployment was enacted and signed by the President on May 1. The
Area Redevelopment Act provides loans to commercial and industrial enterprises, loans and grants for community facilities and urban renewal, all designed to increase employment opportunities in these areas. In addition, the Act provides for the training and retraining of unemployed and underemployed residents of these areas and for the payment of retraining subsistence benefits while in training.

In 1961, 359 redevelopment areas and 9 Indian Reservations prepared and submitted plans for their over-all economic development. Of these, plans covering 247 redevelopment areas and 9 Indian Reservations had been given provisional approval by the end of the year. Eleven projects involving industrial loans, grants and loans for public facilities, and technical assistance contracts were approved. Sixty-six more were under active consideration at the end of the year.

Occupational training programs for unemployed and underemployed persons were initiated in October 1961, under the provisions of the Area Redevelopment Act. As of January 5, 1962, training projects in 17 redevelopment areas located in 7 different States had been approved. These projects provided for the training of 3,500 workers in 45 courses of instruction. Fifty training proposals from as many areas are under active consideration, and an additional 50 are in various stages of preparation in local communities.

9. **Housing**

A Presidential message sent to the Congress on March 9 included the following proposals: a 4-year commitment of $2.5 billion for urban renewal; long-term, low-interest loans for nonprofit limited dividend rental and cooperative housing for moderate income families financed by special assistance from FNMA; expanded public housing and housing for the elderly; authority for FHA to insure long-term home improvement loans; additional aid for urban planning, community facilities, and housing research; an extension of the FHA insurance program for middle-income families to permit in certain cases a 40-year maximum mortgage period, to remove the downpayment requirement, and to make other changes to ease housing credit.

The Housing Act of 1961, incorporating the substance of these proposals, was approved on June 30.

The veterans home loan program was extended by legislation approved on July 6.

10. **Feed Grains Program**

The President signed an emergency feed grains bill on March 22. It authorized the Secretary of Agriculture to make payments to growers on 1961 crops to reduce acreage and output, and to increase support prices for feed grains. Advance payments were begun shortly after the bill was signed.
11. Agriculture

The President sent to the Congress an omnibus farm bill on March 16. A bill signed into law on August 8 extended and liberalized lending programs of the Farmers Home Administration, extended the emergency feed grains program to 1962 crops, authorized a program of payments to producers for reducing wheat acreage in 1962, extended the special milk program and the National Wool Act for 4 years, extended the program for the sale of surplus commodities for foreign currency for 3 years, and authorized marketing orders for additional commodities.

12. Federal-Aid Highways

The President, in a message sent to the Congress on February 28, recommended increased taxes and a schedule of authorizations which would permit completion of the Interstate System in 1972 and an expansion of other Federal-aid highway programs. The Federal-Aid Highway Act of 1961, approved on June 29, provides increased authorization and revenues required to permit completion of the Interstate System by 1972, while maintaining the pay-as-you-build principle.

13. Natural Resources

A Presidential message sent to the Congress on February 23 included a program calling for increased aid for waste treatment facilities and air pollution, expansion of the saline water program, accelerated forest planting, access roads to public forests, purchase of shoreline areas for park sites, and a 10-year program of grants to the States for planning comprehensive water development projects. On July 20, the President signed a bill almost doubling grants for water pollution control and strengthening federal authority to seek abatement of pollution. On September 22, an extension of the saline water program for 6 years was approved, with an authorization of $75 million. To carry out the President's forestry program, appropriations for the Forest Service were substantially increased with particular emphasis on the expanded reforestation program, acceleration of recreational facility development, and strengthening protection against forest fires. Authorization for the Cape Cod National Seashore was signed into law on August 7. In the Housing Act of 1961, approved on June 30, partial grants to localities in an aggregate amount of $50 million were authorized for the acquisition of land for permanent open space in or near urban areas.

14. Airport Aid

Administration bills authorizing construction grants of $75 million a year for 5 years were introduced in both the Senate and the House. A bill signed on September 20 authorized the extension of Federal construction grants to airports for 3 years. A 2-year grant of $150 million was included in the final money bill approved on September 27.
15. Aid to Education

The President sent a special message on education to the Congress on February 20. It included recommendations concerning elementary and secondary schools and higher education.

Elementary and secondary schools: The President recommended that the Congress authorize a 3-year program for school construction and teachers' salaries. The total cost would be $2.3 billion. The Senate passed a school aid program, but the House Rules Committee tabled the proposal.

Higher education: Legislation was proposed to provide more than $3 billion in assistance to higher education. The proposals included the extension and expansion of the low-interest loan program for college housing facilities; authorization of a new 5-year program under which $300 million would be loaned each year for the construction of academic facilities; authorization of a program of 4-year undergraduate scholarships; expanded student loans and fellowships through the National Defense Education Act.

The Administration supported legislation to provide matching grants for establishment of educational television stations and for State surveys of the need for such stations. The Senate passed a bill to authorize aid for establishment of such stations and the House reported a bill out of Committee which was substantially the same as the program submitted.

As part of the Housing Bill signed on June 30, the college housing fund was increased from $1.7 billion to $2.9 billion in four steps by July 1, 1964.

The National Defense Education Act was extended for two years on October 5, continuing the previous $90 million annual authorization for student loans.

16. Health Programs

A Presidential message sent to the Congress on February 9 included the following proposals:

(1) Increased grants for the construction of nursing homes; grants to States for community health programs, and project grants to develop new methods of out-of-hospital care; increased project grants for research into uses of medical facilities, including grants for the construction of experimental and demonstration facilities;

(2) A 10-year program of matching grants for the construction, expansion, and restoration of medical and dental schools with an authorization of $75 million a year and an anticipated first-year appropriation of $25 million;

(3) Authorization of Federal grants to schools for scholarships for medical and dental students;

(4) Increased appropriations for existing maternal and child welfare programs;

(5) Increased vocational rehabilitation grants;

(6) An extended and expanded program of matching grants for the construction of research facilities and increased appropriations for the
medical research and training programs of the National Institutes of Health.

The community health services and facilities bill, approved on September 20, increased from $30 million to $50 million the annual authorization for grants to States for public health services (with particular attention to community health service programs); authorized an additional $10 million a year for project grants to develop new methods of out-of-hospital care; raised from $10 million to $20 million the annual authorization for grants to build public or nonprofit nursing homes; and increased from $1.2 million to $10 million the authorization for research into uses of medical facilities (including construction of experimental facilities).

17. Medical Care for the Aged

The President recommended a health insurance program for those of age 65 or over who are eligible for Social Security benefits. The insurance would be financed by an increase in Social Security payroll taxes. Hospital and home health service benefits would begin October 1, 1962. Nursing home service benefits would begin July 1, 1963. Action by the Congress was postponed.

18. Tax Recommendations

Among his tax recommendations, the President asked for the enactment of an investment tax credit as an incentive for the modernization and expansion of private plant and equipment. He also recommended withholding taxes on interest and dividends and a series of measures to eliminate defects and inequities. This tax program would involve no net loss in revenue. On August 23, the House Ways and Means Committee announced that it was postponing further action until 1962.

19. Special Insurance Dividend for Korean Conflict Veterans

On September 13, the President approved a measure authorizing a one-time special dividend on the otherwise nonparticipating insurance issued to veterans of the Korean conflict. The dividend declaration amounted to $56 million of which approximately $30 million was disbursed to eligible policyholders by the end of calendar year 1961.

20. Small Business Administration (SBA)

Legislative action during 1961 liberalized the Small Business Investment Program and expanded and strengthened the activities of the Small Business Administration. Additional private capital was attracted into small business investment corporations by amendment of the Small Business Investment Act, which increased the maximum amount of Government participation in a single corporation from the previous limit of $150,000 to $400,000. The ability of the SBA to lend to State and local
development corporations was also increased. Amendment of the Small Business Act provided for the development of a program to assure small business participation in subcontracts relating to government procurement, and broadened the authority for research and counseling services for small business.
Chapter 2

Economic Growth

FASTER ECONOMIC GROWTH in the United States requires, above all, an expansion of demand, to take up existing slack and to match future increases in capacity. Unless demand is adequate to buy potential output, accelerating the growth of potential is neither an urgent problem nor a promising possibility. Full utilization will itself contribute to growth of capacity. Saving and investment to increase capacity and improve productivity flourish in prosperity and wane when the economy is slack. Reduction of economic fluctuations lessens the risks associated with innovation and investment and diminishes the resistance to technological change. A full employment economy can achieve more rapid growth than an economy alternating between boom and recession; for that reason, effective stabilization policy is the first step toward a policy for economic growth. But stabilization policy is not enough. A sustained improvement in the growth rate requires also a concerted effort, private and public, to speed the increase of potential output. Chapter 1 has analyzed the current problem of underutilization. In this chapter the emphasis is on the growth of potential output.

The growth of the U.S. economy results primarily from decisions taken by individuals, families, and firms. However, all levels of government—Federal, State and local—have a role in the promotion of economic growth. It is no part of that role to force on unwilling households and business firms any particular rate of growth in their own individual activities. But if, as a Nation, we desire a higher rate of growth, there are two consequences for government policy. First, in those areas of economic activity traditionally allotted to some level of government, public expenditures must provide services which contribute to the growth of potential output and which satisfy the needs that accompany increasing income and wealth. Second, public policy—notably in the fields of taxation, education, training, welfare, and the control of money and credit—inevitably stimulates or retards the growth potential of the private economy, even if no such result is consciously intended. Accelerated economic growth requires coordinated policy at all levels of government to facilitate the increase of productivity and the expansion of capacity. No change is implied in the historic division of responsibility between public bodies and private citizens.
The sources of growth of potential output often present themselves as "problems." A rapidly expanding labor force provides new workers to man factories and perform services, and opens new opportunities for investment to equip them. But it accentuates simultaneously the "problem" of assuring useful jobs at satisfactory wages for an ever-growing number of job seekers. Rapid technological progress increases productivity, releasing labor and other resources for new uses. But it creates simultaneously the "problem" of displaced workers, declining industries, and depressed areas. The problems and the opportunities are opposite sides of the same coin. A commitment to accelerated growth is at the same time a commitment to solve even more such problems. The challenge is to find solutions which do not limit the economy's capacity to grow.

This is what is meant by saying that there are "growing pains" associated with economic progress. They are not new. Nor are they insoluble if the expansion of demand creates new opportunities for labor and capital as old ones disappear. An adequate level of demand, though not itself the solution to structural problems, is a necessary precondition to the solution.

The most pressing of the social problems resulting from rapid industrial progress is the creation of islands of obsolete capacity and unwanted skills. It is inequitable to inflict the costs of progress on an arbitrarily selected few, when the benefits are widely shared. It is more than inequitable—it is self-defeating—to invite resistance to progress, pools of idleness, low productivity, and poverty. The need for specific policies to restore the earning power of displaced workers and the vitality of depressed regions has already been emphasized in connection with the objectives of the Employment Act itself. That need is intensified with the acceptance of accelerated economic growth as a goal of national policy.

Faster economic growth incurs costs and imposes responsibilities. It must—if it is worth undertaking—confer even larger benefits. Potential output has been growing, on the average, at 2.9 percent annually since the turn of the century and at about 4 percent since the end of the second World War, though since 1954 the rate has slowed to 3.5 percent. Yet there are sound reasons for wanting even faster growth in the future—(1) unsatisfied needs at home and (2) threats to freedom abroad.

(1) Per capita disposable personal income, measured in 1961 dollars, has been increasing since 1947 at about 2 percent a year; it surpassed $2,000 a year in the last quarter of 1961. Nevertheless, about 30 percent of all families and unrelated persons have less than $1,000 of money income per person, and are now below the level that the average American achieved a quarter-century ago.

A high rate of economic growth today will enable increasing millions to enjoy better lives tomorrow. Only a limited imagination can fail to see opportunities for providing more fully both such basic needs as food,
clothing and shelter and the amenities of civilized life—education, medical care, travel and recreation.

In many, though not all, contexts growth in per capita production will reduce the number of persons with low incomes. Poverty in the United States is disproportionately concentrated among the aged, the nonwhite, the poorly educated, marginal farmers, and families without a male breadwinner. The disadvantaged fare better in a buoyantly growing economy. But for some, the remedy lies in welfare or insurance payments coupled with substantially improved services and retraining to restore them to self-sufficiency. In the longer run, the provision of good education and adequate health services for the children of these families is essential to break the degrading cycle of dependency.

Other unfilled needs lie in the field of public or mixed public and private expenditures. The renewal of cities, the reconstruction of transportation facilities, the improvement of education at all levels, the provision of new facilities for the arts, the expansion of medical care facilities, the conservation and expansion of our national parks and forests, all these things need more resources than we now devote to them. Economic growth will help create those resources.

(2) The leadership of the free world imposes heavy economic burdens on the United States. The primary responsibility for maintaining the military security of the free world falls on us. Although we hope that world tensions will slacken, we must be prepared if they do not. If the threat rises in intensity, we must increase our defense capabilities to meet that threat. The future needs of defense are uncertain but imperative; the larger and more efficient our economy, the more readily will we be able to shoulder larger military burdens, if we must.

Our responsibility is no less in the global battle against poverty, ignorance, and disease. The less developed nations need our capital and technique. They also need a further demonstration of the ability of a free economy to grow, to prosper, and to use its enhanced resources wisely.

The foreign trade policy of the United States should be formulated with regard for the obvious fact that a more satisfactory rate of economic growth can be achieved here and abroad if producers are stimulated to efficiency by active participation in international trade. A liberal trade policy works to this end by providing increased market opportunities abroad for U.S. products while promoting the efficient utilization of resources through the invigorating effects of foreign competition, whether encountered in our home markets or in the markets of other countries.

**Goals for the Current Decade**

Goals, if they are to be useful, should be neither too easy nor too difficult. To set a goal that would have been achieved anyway serves no useful purpose. To set a goal that is obviously impossible of achievement invites a
loss of confidence and perhaps failure to achieve what is possible. A good target is one that can be met, but not without effort.

This general limitation sets only a range of growth targets for the United States in the 1960's. It is no easy matter to say exactly how fast an economy can grow, or to obtain consensus on how fast it should grow. Some of the benefits of growth have already been discussed. The costs of growth are the diversion of resources from the satisfaction of current needs to those uses which will yield increased output in the future, and the strain on our institutions and social fabric which this diversion might entail. Ultimately, a democratic society achieves one rate of growth rather than another through the freely made economic and political decisions of its citizens. The task of economic analysis is to show what the choices are, what alternative choices will cost, and what benefits they may yield.

The basic determinants of a society's productive capacity in any year are as follows:

1. The number of people available for employment, the number of hours they wish to work, their incentives and motivations, and their health, general education, occupational desires, and vocational skills;
2. The stock of new and old plant and equipment, and its composition by age, type, and location;
3. The terms on which the economy has access to natural resources, whether through domestic production or imports;
4. The level of technology, covering the range from managerial and organizational competence to scientific, engineering, and mechanical understanding;
5. The efficiency with which resources, domestic and foreign, are allocated to different economic ends, and the extent of monopolistic or other barriers to the movement of labor and capital from low-productivity to high-productivity uses.

These basic determinants interact in complex ways. For example, advanced machinery is of little use without skilled labor to operate it; advanced technology often requires capital equipment to embody it.

Next year's productive capacity will exceed this year's to the extent that the basic determinants can be expanded and improved. Success in achieving a higher rate of growth in the future depends on our willingness to spend current resources to expand our production potential and by our skill and luck in spending them effectively.

The record of economic growth in the United States does not suggest that the average growth rate realized in the past is an immutable natural constant, leaving no scope for growth-stimulating policies. The rate of growth of output has varied from one span of years to another, depending on specific economic circumstances (Chart 9). There was one prolonged period of stagnation—the decade of the 1930's—when potential output grew at less than the average long-term rate, and realized output grew more slowly still. Again, there have been periods when poten-
CHART 9

Output, Employment, and Productivity

BILLIONS OF DOLLARS (Ratio scale)

GROSS NATIONAL PRODUCT IN 1961 PRICES

MILLIONS OF PERSONS (Ratio scale)

TOTAL EMPLOYMENT

DOLLARS (Ratio scale)

GROSS NATIONAL PRODUCT PER EMPLOYED PERSON IN 1961 PRICES

1/CIVILIAN EMPLOYMENT PLUS ARMED FORCES.

SOURCES: DEPARTMENT OF COMMERCE, DEPARTMENT OF LABOR, AND COUNCIL OF ECONOMIC ADVISERS.
tial output expanded more rapidly than the past average. The postwar years have been such a period of accelerated growth. Even including the years since 1954, during which growth was sluggish, real gross national product (GNP) in this postwar period has increased at an average annual rate of 3.5 percent. Had potential output been realized in 1960, as it was in 1947, the realized growth rate would have been 4.0 percent a year.

Table 10 shows, for the 1947–60 period, the increases in realized and potential GNP, population, labor force, employment, man-hours, GNP per person, and productivity. Approximately four-fifths of the annual increase in potential GNP during the period is explained by increases in output per man-hour and one-fifth by increases in total man-hours worked. The increase in output per man-hour is, of course, the resultant of improvements in the quality of the labor force, the quantity and quality of capital, the level of technology, and still other factors.

| Table 10.—Output, population, labor input, and productivity, 1947–60 |
|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Item            | Unit            | 1947            | 1954            | 1960            | Percentage change per year |
|                 |                 | 1947 to 1954    | 1954 to 1960    | 1947 to 1960    |                  |
| Gross national product | Billions of dollars, 1961 prices | 324.9 | 422.0 | 511.1 | 3.8 | 3.2 | 3.5 |
| Potential gross national product | do | do | do | do |
| Population | Millions of persons | 144.1 | 162.4 | 180.7 | 1.7 | 1.8 | 1.8 |
| Labor force | Millions of persons | 61.8 | 67.8 | 73.1 | 1.3 | 1.3 | 1.3 |
| Employment | do | do | do | do | do |
| Potential employment | do | do | do | do | do |
| Man-hours | Billions of man-hours | 120.6 | 132.9 | 139.7 | .4 | .8 | .6 |
| Potential man-hours | do | do | do | do | do |
| GNP per capita | Dollars, 1961 prices | 2,255 | 2,599 | 2,828 | 2.0 | 1.4 | 1.8 |
| Productivity: | | | | | | |
| GNP per worker | Dollars, 1961 prices | 5,470 | 6,573 | 7,386 | 2.7 | 2.0 | 2.3 |
| Potential GNP per worker | do | do | do | do | do |
| GNP per man-hour | do | 2.51 | 3.18 | 3.66 | 3.4 | 2.4 | 2.9 |
| Potential GNP per man-hour | do | do | do | do | do |

1 Data include Alaska and Hawaii.
2 Same as actual in 1947; in 1954 and 1960, calculated from 3.5 percent trend line through mid-1955.
3 Includes armed forces.
4 Assumes 4 percent unemployment rate for all periods, with no adjustment for cyclical movement of the labor force.
5 Same as actual in 1947; in 1954 and 1960, assumes 4 percent unemployment rate and corrects for decline in hours induced by recession.

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

But consideration of the years 1947–60 as a unit masks significant differences within the period. There was a substantial slowing down in the growth of potential output between the first and the second part of this period. From 1947 to 1954, potential GNP grew at a rate of 4.4 percent a year, and from 1954 to 1960 at a rate of 3.5 percent. Since the labor
force grew at a rate of 1.3 percent a year in both periods and average hours worked fell somewhat more slowly after 1954 than before, the slower rate of growth that has taken place since 1954 is explained by a decline in the rate of increase of productivity. This decline resulted in part from a more slowly rising trend of productivity within nonmanufacturing industry, and in part from a shift—usual in slack periods—from manufacturing to nonmanufacturing in the composition of economic activity.

Further evidence that modern industrial economies are not helpless prisoners of past long-term trends is to be found in Table 11, which shows that the major countries of Western Europe, and Japan as well, have recently exceeded their own long-term performances.

Table 11.—Growth of gross national product per man-year, selected countries, 1913–59

<table>
<thead>
<tr>
<th>Country</th>
<th>1913–59</th>
<th>1950–59</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>2.6</td>
<td>6.1</td>
</tr>
<tr>
<td>Italy</td>
<td>1.7</td>
<td>4.7</td>
</tr>
<tr>
<td>Germany</td>
<td>1.4</td>
<td>4.5</td>
</tr>
<tr>
<td>France</td>
<td>1.5</td>
<td>3.6</td>
</tr>
<tr>
<td>Netherlands</td>
<td>1.3</td>
<td>3.4</td>
</tr>
<tr>
<td>Norway</td>
<td>1.9</td>
<td>3.1</td>
</tr>
<tr>
<td>Sweden</td>
<td>1.7</td>
<td>2.8</td>
</tr>
<tr>
<td>United States</td>
<td>1.8</td>
<td>2.2</td>
</tr>
<tr>
<td>Canada</td>
<td>1.5</td>
<td>2.0</td>
</tr>
<tr>
<td>Denmark</td>
<td>1.2</td>
<td>1.8</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>.8</td>
<td>1.7</td>
</tr>
</tbody>
</table>

Note.—Gross national product at constant prices was used wherever available. See National Institute Economic Review, No. 16, July 1961, pp. 36 and 46-47, for data and description of sources of materials used. Source: National Institute of Economic and Social Research.

On June 28, President Kennedy stated that a growth rate of 4.5 percent yearly is “well within our capability.” On November 17, the United States joined with the other 19 member nations of the Organization for Economic Cooperation and Development in setting as a target the attainment of a 50 percent (4.1 percent a year) increase in their combined national product during the decade from 1960 to 1970. The ability of the United States to meet, and even to exceed, this target is the best guarantee of success for the OECD. A high rate of growth of potential output will not be reached immediately. The policies to achieve it, even if adopted now, will not bear fruit at once, and it will not be achieved without effort. But in the second half of the decade, with the help of a rapidly growing labor force, it should be possible to exceed a growth rate of 4.5 percent annually and to achieve an average rate of growth of potential output of 4.3 percent between 1960 and 1970.

If this growth is achieved and if, in addition, 1970 is a year of 4 percent unemployment, actual GNP will grow at an average annual rate of 4.9 percent (Table 12). The difference between this figure and 4.3 percent reflects the current shortfall of actual output from potential output. Such a rate of growth of total GNP would mean an annual increase of GNP per person in the population of 3.2 percent, nearly double the rate achieved during
Table 12.—Output, population, labor input, and productivity, 1960 actual and 1970 illustrative

<table>
<thead>
<tr>
<th>Item</th>
<th>Unit</th>
<th>1960 1</th>
<th>1970 illustrative 2</th>
<th>Percent- age change per year 1960-70</th>
</tr>
</thead>
<tbody>
<tr>
<td>Output:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross national product</td>
<td>Billions of dollars, 1961 prices</td>
<td>511.1</td>
<td>825</td>
<td>4.9</td>
</tr>
<tr>
<td>Potential gross national product</td>
<td>do</td>
<td>541.8</td>
<td>825</td>
<td>4.3</td>
</tr>
<tr>
<td>Population</td>
<td>Millions of persons</td>
<td>180.7</td>
<td>213.8</td>
<td>1.7</td>
</tr>
<tr>
<td>Labor input:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Labor force</td>
<td>do</td>
<td>73.1</td>
<td>87.1</td>
<td>1.8</td>
</tr>
<tr>
<td>Employment 3</td>
<td>do</td>
<td>69.2</td>
<td>83.7</td>
<td>1.9</td>
</tr>
<tr>
<td>Man-hours</td>
<td>Billions of man-hours</td>
<td>139.7</td>
<td>162</td>
<td>1.5</td>
</tr>
<tr>
<td>Potential man-hours</td>
<td>do</td>
<td>143.1</td>
<td>162</td>
<td>1.2</td>
</tr>
<tr>
<td>GNP per capita</td>
<td>Dollars, 1961 prices</td>
<td>2,828</td>
<td>3,858</td>
<td>3.2</td>
</tr>
<tr>
<td>Productivity:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GNP per worker</td>
<td>do</td>
<td>7,386</td>
<td>9,888</td>
<td>2.9</td>
</tr>
<tr>
<td>Potential GNP per worker</td>
<td>do</td>
<td>7,718</td>
<td>9,459</td>
<td>2.5</td>
</tr>
<tr>
<td>GNP per man-hour</td>
<td>do</td>
<td>3.66</td>
<td>5.09</td>
<td>3.4</td>
</tr>
<tr>
<td>Potential GNP per man-hour</td>
<td>do</td>
<td>3.79</td>
<td>5.09</td>
<td>3.0</td>
</tr>
</tbody>
</table>

1 Potential series for 1960 based on the following assumptions: GNP, calculated from 3.5 percent trend line through mid-1955; employment, 4 percent unemployment rate; man-hours, 4 percent unemployment rate and correction for decline in hours induced by recession.
2 Illustrative figures for 1970 based on the following assumptions: Potential GNP growth rate of 4.3 percent per year from 1960 to 1970, with actual and potential being the same in 1970; population, 1955-57 fertility levels continue to 1980; labor force, participation rate of 57.8 percent of noninstitutional population 14 years of age and over; employment, 4 percent unemployment rate; man-hours, continuation of previous trend.
3 Includes armed forces.

NOTE.—Data includes Alaska and Hawaii.

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

the 1947–60 period. It is this figure which most nearly measures the gain to society from accelerated economic growth. If, by 1970, we succeed in achieving an unemployment rate below 4 percent, even further increases in output will become possible. To a first approximation, each 1 point decline in the 1970 unemployment rate would add about $8 billion to 1970 GNP and about 0.1 to the annual rate of growth.

Table 12 is in no sense a prediction of what will actually occur. It shows what would be required to move up to and beyond a 4.5 percent growth rate, giving us a rate of growth of potential for the full decade averaging 4.3 percent a year. Demographic factors lay the foundation for a significant acceleration of potential output. If labor force projections are realized and if past trends in hours worked per man year continue, available labor input will increase during the 1960's at more than one and one-half times its rate of growth during the 1947–60 period. With this increase in labor input, it is a matter of arithmetic that a 3 percent yearly increase in man-hour productivity would be needed if the annual rate of growth of potential GNP is to average 4.3 percent over the decade.

The required growth of output per man-hour was surpassed in the 1947-54 period, but since 1954 performance has fallen below what is required. The vigorous growth of the early postwar period benefited from the possi-
bility of renewing a capital stock which had aged during the depression and war years of low investment. Making good this backlog of investment demand brought with it the quick realization of latent technological progress. Simple continuation of recent trends will not be sufficient to repeat that performance. The rest of this chapter suggests the kind of effort in education, technological development, capital formation, and other areas that may be required to do so. In particular, unless technical progress brings an unexpected increase in the productivity of capital, a major rise in capital investment will be needed.

The population upsurge which began in the 1940's, together with the expected decline in death rates, will give us a rapid increase in the population of working age. Adult women are expected to enter the labor force in increasing proportions; but because a larger fraction of our youth will remain in school and because the trend toward earlier retirement among male workers is likely to continue, over-all labor force participation rates are expected to remain steady. The resultant of these factors should be a labor force in 1970 of a little more than 87 million, an annual rate of increase of 1.8 percent in this decade, compared with the distinctly lower rate of 1.3 percent from 1947 to 1960. If 4 percent of the labor force is unemployed in 1970, total employment will come to 83.7 million. A reduction in the unemployment rate to 3 percent would add over 800,000 to employment.

The calculations of Table 12 assume that the average number of hours worked a year will continue to decline at the same rate as in the past. This reduction in the intensity of work has been going on for a long time. It will continue, both because our citizens choose to enjoy some part of their increased productivity in the form of longer vacations and perhaps a shorter workweek, and because much of the increase in the labor force will consist of part-time workers by preference, notably young people still in school and women with family responsibilities. Full employment will, however, eliminate one possible cause of a decline in average hours; when unemployment rates are high, as they are at present, pressure builds up for a reduction in the workweek. This pressure, motivated by a desire to share the limited volume of employment, is to be sharply distinguished from the desire for increased leisure reflected in the long-run decline in average annual hours. The second of these is to be honored; the first should be met by expanded employment opportunities. Variations in the number of hours worked, like variations in participation rates, also respond to economic forces in other ways. The lure of job opportunities in a growing and prospering economy may attract even more than the expected number of people into the labor force, and may induce some to abandon part-time for full-time work. On the other hand, it is also possible that full employment at the rising wage and salary levels permitted by rising productivity will lead some secondary wage earners to withdraw from the labor force, and others to retire at an earlier age.
The beneficial effects of labor force growth do not occur automatically. Productivity is preserved and increased primarily through acts of investment: investment in the improvement of human resources, in the creation of new technical and managerial knowledge, in the development of natural resources, and in the formation of physical capital. In the case of investment in human capital and in research and development, the link between expenditure and yield is difficult to measure, but there can be little doubt that the return is substantial. In regard to investment in plant and equipment and the development of natural resources, there is more statistical evidence available. No one of these investments can make its full contribution to the objective of accelerated growth without the others. Each of them is necessary; there is good reason to believe that together they can be sufficient, if vigorously pursued.

Investment in Human Resources

Increased production is not an end in itself but only a means of providing increased real income for all to share. As indicated earlier, this is one of the reasons that more rapid growth is a desirable social goal. High levels of education and health, equality of opportunity—these are among the valid measures of a society's performance. They are desirable in their own right. In addition, they have an economic dimension. They are among the foundations of growth as well as among its benefits.

Americans have long spoken of foregoing consumption today in order to invest in their children's education and thus in a better tomorrow. For an economy, just as for an individual, the use of the word invest in this connection is clearly justified, since it is precisely the sacrifice of consumption in the present to make possible a more abundant future that constitutes the common characteristic of all forms of investment. That devoting resources to education and health is, in part, an act of investment in human capital explains why programs in the area of education and health are economic growth programs. This kind of investment has a long and remarkable history. Rough estimates, which take into account differences in the length of the school year and in school attendance, suggest that the stock of equivalent school years in the labor force rose more than sixfold between 1900 and 1957. The annual rate of growth of the stock of education was more than 3 percent, or about twice the rate of growth of the labor force itself.

Failure to pursue vigorous educational and health policies and programs leads to smaller increases in output in the long run; it is also associated with higher expenditures in the short run. If we fail to invest sufficiently in medical research, we lose not only what stricken individuals might have produced had they been well, but also the use of the resources and funds currently devoted to their care. Failure to invest sufficiently in education means that we will lose the additional output that would be possible with a better educated labor force; it may also mean the perpetuation of social
problems necessitating public expenditures. Recognition of the costs of inadequate investment in social welfare is one of the reasons for the Administration's concern to strengthen family services in the public welfare field.

It is a waste of resources to restrict health and education to those who can afford them. Moreover, in addition to each person's interest in his own health and education, there is a public interest in everybody's health and education. The well-being of each citizen contributes to the well-being of others. As a result, we have organized programs to help the population to obtain a quality education, to require attendance in schools, to help ourselves and others to obtain needed medical care, to require that certain medical precautions, such as vaccinations, be taken by everyone.

**Education**

Estimates made by private scholars suggest that about one-half of the growth in output in the United States in the last 50 years has resulted from factors other than increases in physical capital and man-hours worked. Education is one of the "other factors." Even without allowance for the impact of education on invention and innovation, its contribution appears to account for between one-fourth and one-half of that part of the increase of output between 1929 and 1956 not accounted for by the increased inputs of capital and labor. Education is of vital importance in preparing the skilled labor force demanded by new investment and new technology.

Education's contribution to output is reflected by the well-documented fact that income—a measure of each individual's contribution to production—tends to rise with educational attainment. Of course, not all differences in money income are the result of education. Differences in native ability as well as parental economic and social status are also reflected. Nevertheless, a substantial proportion of the increase in income at increasing levels of education may be attributed to that education.

In 1930, $3.2 billion (3.3 percent of GNP in current prices) was spent for all schools at all levels of education. In 1960, expenditures had risen to about $24.6 billion (5.0 percent of GNP). In turn, in 1930, 29.0 percent of the population 17 years old graduated from high school. By 1958 this was true for 64.8 percent. Similarly, in higher education the number of earned degrees conferred rose from 140,000 in 1930 to 490,000 in 1960.

Though significant progress has been made, substantial opportunities and needs for investment in education still exist. There is a pressing need to improve curricula and teaching methods, make education more readily available to students of merit by reduction of financial barriers, expand facilities and staff to meet rising enrollments, improve the quality and productivity of our teaching staffs and increase their salaries, and narrow the gap in opportunities available to students in different parts of our country. These problems must be met—and met quickly—at all levels of government and at all levels of education if our standards of education are to keep abreast of our needs.
The program of the Administration includes specific proposals designed to meet urgent needs in the field of education: increased funds for scholarships; assistance to institutions of higher education for the construction of facilities; aid to the States for assistance to public elementary and secondary schools; and a program to improve the quality of elementary and secondary education through curriculum research, demonstration projects, teacher training institutes, and special project grants.

Work of this last kind has been begun, with the support of the National Science Foundation, in supplementary training of teachers of science and mathematics, especially in high schools, and in the development of new courses in physics, mathematics, chemistry, and biology. Similar support has been given by the U.S. Office of Education for improvement in courses in English and modern foreign languages; it should be extended to the other major academic fields.

Student opportunities. Of each 1,000 pupils who entered the fifth grade in 1952, 900 entered high school in 1956, 600 graduated from high school in 1960, and 300 entered college in the fall of 1960. Thus 40 percent of the original 1,000 students did not graduate from high school and half of those graduating from high school did not enter college. Many of these withdrawals are by children of better than average intelligence. It is generally agreed that improvement of teaching and expansion of guidance and counseling services will help to reduce the drop-out rate. Efforts to eliminate this waste of human resources have already begun, but more are needed.

Financial barriers to secondary education come chiefly from a pressing need for immediate income for the family. At the college level, the financial problem arises both from the direct costs of attending college and the income foregone. The Office of Education estimates that in the 1961-62 school year the average direct costs of attending public colleges are about $1,700 a year, and of attending private colleges, $2,300. These costs have risen rapidly in recent years, and they are expected to continue to rise. They are significant obstacles for large parts of our population. The Administration proposal for assistance to higher education would authorize 4-year scholarship aid for 212,500 capable students in need of financial assistance.

Personnel and facilities. Enrollments in elementary and secondary schools rose from 28.2 million pupils in 1950 to 42.5 million in 1960. Enrollment in 1970 is expected to be 53.0 million. In 1950, 2.3 million students were enrolled in institutions of higher education, and by 1960 the figure had risen to 3.6 million. The projected 1970 enrollment is 7.0 million. Rising enrollments have necessitated substantial expansion of personnel and facilities. Further expansion is required if quality is not to deteriorate.

Our educational system thus confronts unprecedented challenges. To accommodate doubled enrollments by 1970, outlays for college facilities must be more than doubled; total expenditures must rise two-to-threefold.
Needs at the below-college level, about the same in dollar terms, must also be met, lest the foundations of the educational system be eroded. The price of failure will be the irrevocable loss of valuable talent.

However urgent the need for additional facilities and for the rehabilitation and replacement of existing facilities, the personnel problem is especially acute, because of the time required to train teachers. Among beginning teachers in public elementary and secondary schools in 1956-57, 27 percent lacked a standard certificate, a bachelor's degree, or both. Demand for new teachers and for replacement of those leaving the profession will be very high. It can be met only by the training of new teachers, accompanied by programs to increase the productivity and quality of experienced teachers. Teachers' salaries at all levels must continue their recent rise if good teachers are to be attracted into and retained in the profession of educating the Nation's youth. Other programs for expansion of the educational system cannot succeed unless the rewards to teaching are increased.

State differences. In a highly mobile and interdependent society, the lack of educational opportunities is not simply a matter of concern to some States; it is of concern to the Nation. The support that the different States (and different areas within States) give to education varies substantially. Such support depends not only on the commitment that the population has to education, but also on the resources of the State and the number of children seeking a public education. As a consequence, some States with low per student expenditures for education have educational budgets that, as a percentage of personal income, are far above the national average. Increased Federal support for education, as outlined in the President's proposals, is essential to eliminate these imbalances as well as provide for programs to meet the national responsibilities that transcend State and local boundaries. Ultimately, the effectiveness of our democracy rests on an educated and informed citizenry.

Health

U.S. economic growth in the twentieth century has been associated with better health of the population as a whole as well as an increase in per capita expenditures on health and medical care. Public and private expenditures on health care increased from $3.6 billion, or 3.5 percent of GNP, in 1929 to $26.5 billion, or 5.4 percent of GNP, in 1960. This has been accompanied by a sharp increase in life expectancy and a reduction in death rates from communicable diseases.

At the same time that economic growth has contributed to an improvement in the health of our people, better health has contributed to economic growth. Better health makes possible an increase in the size of the labor force and in the effectiveness of effort on the job.

Further improvements in health would yield significant economic, as well as human, benefits. On an average day in 1960, 1.3 million employed persons—2 percent of civilian employment—were absent from work be-
cause of illness or accident. The days of work lost because of illness far exceeded the days of work lost because of industrial disputes; in fiscal year 1960, "currently employed" persons lost a total of 371 million days from work as a result of illness or injury, while the loss from industrial disputes in 1960 totaled 19 million days.

The costs of ill health have traditionally been calculated as the money spent for the prevention and treatment of accident and disease. The waste of human resources and the consequent loss of production is an important additional cost about which not enough is known. Where facts are available, as in the related area of vocational rehabilitation, the relationship between costs and benefits is impressive. In 1960, at an average cost of $900 per rehabilitant under Federal-State programs, median wages of rehabilitated persons were raised from $450 a year at acceptance to $2,350 at closure, a difference of $1,900 in the first year after rehabilitation.

Public support for medical research, the most basic of investments in better health, has been growing. In fiscal year 1962, total expenditures will exceed a billion dollars, of which 60 percent is supported by the Federal Government. Further expansion of research activities, where funds can be wisely spent and where qualified research personnel exist, is desirable both for humanitarian and economic reasons. Much of the necessary research is carried on by doctors of medicine. More rapid expansion of the number of physicians is required to insure that patient care needs, teaching needs, and research needs can all be met. This will be true even if needed improvements are made in the organization and financing of medical care.

Increased demands for medical services, stemming in part from new discoveries and in part from growth in population and changes in age and income structure, already mean unfilled internships and residencies in hospitals. The full medical needs of the country are not being met in many fields, including public health and preventive medicine. The Administration has presented a program to authorize Federal grants for the construction of medical, dental, osteopathic, and public health teaching facilities, project grants to plan for new facilities and improved educational programs, and scholarship aid to students. The importance of maintaining and improving the health of the Nation makes the enactment of this program a matter of great urgency.

**Eliminating Racial Discrimination**

Racial discrimination is a national disgrace. In this respect, above all others, practice in the United States is a standing affront to professions of democratic principle. Discrimination inflicts immeasurable human and social costs on a large number of our citizens. In addition—and this is why it deserves particular mention in this Report—it inflicts an economic loss on the country.

Discriminatory practices in education, training, employment and union membership impede the development and utilization of human resources.
They reduce the efficiency and slow the growth of the economy, at the same time that they alter—and alter inequitably—the distribution of the fruits of economic progress.

Although significant reductions in discriminatory barriers have been accomplished in recent years, important problems remain. Many nonwhite families are trapped in a vicious circle: Job discrimination and lack of education limit their employment opportunities and result in low and unstable incomes; low incomes, combined with direct discriminations, reduce attainable levels of health and skill and thus limit occupational choice and income in the future; limited job opportunities result in limited availability of vocational education and apprenticeship training. Unless action is taken, today's training practices, affecting tomorrow's employment possibilities, will help to perpetuate inequitable employment patterns.

Our economy loses when individuals who are capable of acquiring skills are denied opportunities for training and are forced into the ranks of the unskilled, and when individuals with education, skill, and training face discriminatory hiring practices that result in their employment in low productivity jobs.

Discrimination is reflected in the distribution of income and in disparities in the levels of education attained by white and nonwhite groups. Nonwhite families had a median money income of $3,233 in 1960. Although this represents a remarkable advance over the figure of $2,099 for 1947 (in 1960 prices), the magnitude of the problem still remaining is indicated by the fact that in 1960 the median income for white families was $5,835. In 1960, 11.0 percent of white but 31.7 percent of nonwhite families had money incomes of less than $2,000, while 36.6 percent of white but only 13.6 percent of nonwhite families had money incomes of $7,000 and over.

In 1947, 11 percent of the nonwhite population 14 years of age and over was illiterate; by 1959, this percentage had dropped to 7.5, with declines registered in every age group. The figure was, however, considerably higher than the 1.6 percent illiterate in the white population. Equally disturbing is the fact that in the nonwhite population the percentage of illiterates was higher for each age and sex group than the comparable percentage for the white population. While the median school years completed for the nonwhite population 25 years of age and over had risen from 5.8 in 1940 to 8.1 in 1959, the median for the total population was 11.0 in 1959.

The unemployment rate in December 1961 was 5.2 percent for white males and 4.7 percent for white females, but 12.4 percent for nonwhite males and 10.7 percent for nonwhite females. Nonwhite workers made up less than 12 percent of the labor force, but accounted for 22 percent of the total unemployed and 24 percent of those unemployed 15 weeks or more.

Economic growth will be furthered by the adoption of nondiscriminatory policies and practices to insure that all Americans may develop their abilities to the fullest extent and that these abilities will be used.
ment of Justice, the President's Committee on Equal Employment Opportunities, and the U.S. Commission on Civil Rights are already acting vigorously. They should be joined in the campaign by all parts of our population and all units of government, business, and labor.

**Investment in Technological Progress**

Technological knowledge sets limits on the productivity of labor and capital. As the frontiers of technology are pushed ahead, industrial practice and productivity follow, sometimes pressing close on the best that is known, sometimes lagging behind, with the gap varying from industry to industry and from firm to firm. A stimulus to economic growth can come either from increasing the rate at which the frontiers are advancing or from bringing the technology actually in use closer to the frontiers.

**Research and Development**

The advance of technological knowledge depends on the amount and effectiveness of the human and material resources devoted to research and development. The limited data available suggest that within industries and between industries there is a positive correlation between research effort and productivity growth. However, some of the most important developments affecting the productivity of a firm or industry may originate from research done by equipment and material suppliers, or from basic research done by government and the universities. The benefits of research activity are often widely shared.

Expenditures on research and development in 1960 totaled about $14 billion, as shown in Table 13. In 1961 the total was probably in the neighborhood of $15 billion, nearly three times the expenditures in 1953, and almost a third as large as business expenditures on fixed capital. After rough allowance for rising costs, the volume of research and development performed has approximately doubled since 1953.

### Table 13—Research and development expenditures, 1953 and 1957–60

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<tr>
<td><strong>Total expenditures</strong></td>
<td>5.15</td>
<td>10.03</td>
<td>11.07</td>
<td>12.62</td>
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<tr>
<td><strong>By type of research:</strong></td>
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<tr>
<td>Basic research</td>
<td>.43</td>
<td>.83</td>
<td>1.02</td>
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<td>Applied research and development</td>
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<td>Federal Government</td>
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<td>Industry</td>
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<td>Universities and other nonprofit institutions</td>
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<td>.26</td>
<td>.26</td>
<td>.30</td>
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<td><strong>By performer:</strong></td>
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<tr>
<td>Federal Government</td>
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<td>1.44</td>
<td>1.73</td>
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<td>Industry</td>
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<tr>
<td>Universities and other nonprofit institutions</td>
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<td>.93</td>
<td>1.04</td>
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</tbody>
</table>

1 Based on reports by performers.

2 Includes research centers administered by organizations in this sector under contract with Federal agencies.

Source: National Science Foundation.
and 1960, research and development as a percentage of GNP in current prices doubled from 1.4 percent to 2.8 percent.

Research and development cover a wide range of activities aimed at increasing the stock of scientific and technical knowledge. As we move from basic research to applied research and to development, the goals become more closely defined in terms of specific practical objectives, the predictability of the results increases, and the benefits become less diffuse. More than 90 percent of research and development spending is for applied research and development—most of it for development. Slightly less than 10 percent is for basic research.

Approximately three-fourths of the Nation's total research and development effort is performed by industry, and over half of this is financed by the Federal Government. Profit considerations naturally lead private firms to concentrate on developing and improving marketable products. Even here, supplementary government support can pay off handsomely. Estimates suggest that hybrid corn research, of which perhaps one-third was publicly supported, yielded a substantial return to society over and above the returns to farmers and seed producers.

Less than one-third of all basic research is done by industry. Government, the universities, and other nonprofit institutions, although doing only one-fourth of total research, do most of the Nation's basic research. Such research seldom results directly or immediately in new products and processes. But in the long run, basic research is the key to important advances in technology. Fundamental inventions like the transistor—an outgrowth of basic research in solid-state physics—may revolutionize large sectors of industry and have a tremendous ultimate effect on productivity.

Although research and development spending is increasing rapidly in most industries, more than 55 percent of industrial research is performed by two industry groups, the aircraft and parts industry, and the electrical equipment and communications industry, as shown in Table 14. This heavy concentration of industrial research reflects primarily the concentration of defense contracts.

Industrial research is also heavily concentrated in large firms. In 1958, firms employing more than 5,000 persons accounted for 84 percent of total industrial research spending, significantly more than the share of these firms in manufacturing employment.

The Federal Government plays a much larger role in financing than in performing research. It is estimated that in 1961 the Government paid for about two-thirds of the total national research effort including, in addition to work done in government laboratories, almost 60 percent of the research undertaken in industry-run laboratories and over 70 percent of the research done by universities. About 70 percent of government research and development spending is accounted for by the Department of Defense. The Atomic Energy Commission and National Aeronautics and Space Administration together account for nearly 20 percent.
Table 14.—Funds for industrial research and development, by source and industry, 1960

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<th>Funds for research and development, 1960</th>
<th>Research and development funds as percent of net sales, 1959</th>
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<td>Food and kindred products</td>
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<td>Paper and allied products</td>
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<td>Stone, clay, and glass products</td>
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<td>8.8</td>
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<td>Other industries</td>
<td>358</td>
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</table>

1 Data apply to all manufacturing industries and to the communication and crude petroleum and extraction nonmanufacturing industries.
2 Percent change not computed for an industry where the amount in the base period was less than $15 million.
3 Not available.

Note.—Detail will not necessarily add to totals because of rounding.
Source: National Science Foundation.

In addition to its direct contributions to research and development spending, the Federal Government has stimulated private research and development activity. The science information services of the National Science Foundation, the Atomic Energy Commission, the Office of Technical Services of the Department of Commerce, and other government agencies contribute to the over-all efficiency of national research and development. Federal tax law encourages research and development by making such costs fully deductible in the year they are incurred. The Small Business Act encourages spending on research and development, including cooperative research, by small companies. Moreover, the Federal Government makes an important contribution to the training of future research scientists and engineers through its support of education and basic research in the universities.

Strengthening research and development. During the 1950's, the number of professional scientists and engineers in the United States increased at an annual rate of approximately 6 percent. Total resources allocated to research and development grew at an even faster rate because a rising proportion of all scientists and engineers were engaged in research, and because supporting personnel, equipment, and material per research scientist increased. During the 1960's, these trends will continue, but one limit to growth will be the supply of scientists and engineers in certain fields. Future investment in research will be limited largely by the quantity and quality of earlier investment in education.
Overemphasis on current research and development activity should not be permitted to erode the underlying educational base. Just as research is investment for the economy, education is investment for research. The needs for educational expansion stressed earlier in this chapter include urgent requirements for laboratories, laboratory equipment, and other science teaching facilities.

A greater share of research and development resources and talent should be devoted to basic research and to prototype development and experimentation in fields which promise major advances in civilian technology. Military research helped to create such important discoveries as isotope medicine, the computer, and the jet engine. The important impact on civilian technology of these offspring of military research suggests that high returns might be achieved if sights were set higher in nonmilitary research. Since the risks of basic research and experimental development are very great, and since the rewards for success are not confined to single firms or even industries, there is a case for public support to attract additional resources into this work.

In a number of industries, firms which are highly efficient in production and marketing may be too small to undertake an efficient research and development program. In others, a research tradition is lacking, or research is discouraged because the benefits tend to diffuse beyond the market grasp of individual firms. In agriculture, all these conditions are present, and the high returns to society from government support of research suggest that comparable programs to increase research in certain manufacturing industries might be highly desirable.

An Administration bill to create an Assistant Secretary of Commerce for Science and Technology has passed the Senate and is now pending before the House. Its enactment would be an important step in fulfilling the Government's responsibilities in this area. The competence and experience of the National Bureau of Standards could well be used in support of a program to fill the gaps in the national industrial research effort.

More Effective Use of Existing Technology

(1) In some industries there are legal obstacles to technical change. The housing construction codes of many localities provide a prominent example. In principle, these codes protect the public from shoddy construction; in practice, they often prevent the use of new materials, designs, and techniques which are superior to the old, and a lack of uniformity among codes in different localities discourages mass production of certain prefabricated housing components. With respect to construction codes in particular, the Housing and Home Finance Agency should continue to encourage the adoption of performance standards for codes and should strengthen its programs of testing and evaluation.
(2) American labor has a remarkable record of acceptance of new technology; but understandable resistance to the displacement of labor by new equipment has occasionally developed when opportunities for retraining and re-employment were not clearly visible. The Federal Government can help considerably, first, by pursuing effective policies to maintain full employment, and second, by expanding and improving its programs in job training and retraining.

(3) The process of technological change would be smoother if society knew better how to reap the rewards and reduce the costs. Research in the social, behavioral, and managerial sciences can lead to more efficient use of resources and to quicker grasp of the opportunities afforded by technological progress. Improved understanding may, in time, yield ways to ease the burdens of adjustment. Strengthening of research in these auxiliary fields is needed to gain maximum benefit from research which creates new technology.

(4) Innovation is facilitated by a flow of information about new technical developments. Since many firms, especially small ones, are not in a position to follow new technological developments closely, the Government can play a useful role by providing business with relevant information and analysis. These service functions of the Department of Commerce and the Small Business Administration should be substantially strengthened. The success of the Federal-State Extension Service in speeding the diffusion of agricultural technology serves to illustrate how effective such programs can be.

(5) The Panel on Civilian Technology, composed of a group of distinguished scientists, engineers, businessmen, and economists, has been brought together under the joint auspices of the office of the President's Special Assistant for Science and Technology, the Department of Commerce, and the Council of Economic Advisers. The panel is examining opportunities for stimulating civilian research and development as well as for more effective use of existing technology. It has begun to address itself particularly to those sectors of our economy where major social and economic benefits could be expected to accrue from technological advances.

(6) By eliminating monopolistic and collusive barriers to the entry of new business and by maintaining the spur of competition to innovation and the utilization of technology, antitrust enforcement tends to create conditions which encourage economic growth. (See Chapter 4.)

INVESTMENT IN PLANT AND EQUIPMENT

Between the resourcefulness of the labor force and the ideas of the laboratory on one side and the satisfaction of consumption needs on the other, the indissoluble link is the economy's stock of plant and machinery. Our own history and the experience of other industrial countries alike demonstrate the connection between physical investment and growth.
of productive capacity. Without investment in new and renewed plant and equipment, skills and inventions remain preconditions of growth; with it, they become ingredients.

**Investment as a Source of Growth**

Investment in fixed capital leads to increased capacity both by equipping new members of the labor force with capital up to existing standards and by providing greater amounts for all workers. Since 1929, the stock of privately owned plant and equipment (in constant prices) has grown relative to private man-hours worked by nearly 80 percent (Chart 10) and by nearly 50 percent relative to the private labor force. Nearly all of the latter increase has taken place during the postwar period. Between 1929 and 1947, the rate of investment was sufficient only to provide enough capital—although more modern capital—to keep pace with a growing labor supply. No increase in capital per worker occurred. Since 1947, the rate of growth in the ratio of capital stock to labor supply has been approximately 2.7 percent a year, but there is a perceptible difference between the growth records of the first and second halves of the postwar period. From 1947 to 1954, the amount of capital per worker increased by 3.5 percent a year; in contrast, the annual increase from 1954 to 1960 averaged only 1.9 percent.

**CHART 10**

**Indexes of Business Output, Capital Stock, and Man-Hours**

INDEX, 1929 = 100 (Ratio scale)

INDEXES BASED ON DATA IN CONSTANT PRICES. SEE TABLE 15 FOR DEFINITIONS.

SOURCE: COUNCIL OF ECONOMIC ADVISERS (BASED ON DATA FROM VARIOUS GOVERNMENT AND PRIVATE SOURCES).
The importance of investment in the growth process is suggested by the parallel movement of the growth of potential output per man and the growth of capital per man (Table 15). Both ratios grew more rapidly after 1947 than before, and more rapidly between 1947 and 1954 than subsequently. In general, the experience since 1929 supports the belief that the more rapidly the capital stock grows relative to the labor force, the greater will be the growth in potential output per worker, provided that other necessary conditions are met.

**Table 15.—Growth in business potential capital-labor and output-labor ratios, 1929–60**

<table>
<thead>
<tr>
<th>Item</th>
<th>1929 to 1947</th>
<th>1947 to 1954</th>
<th>1954 to 1960</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital stock per worker 1</td>
<td>0.0</td>
<td>2.7</td>
<td>3.5</td>
</tr>
<tr>
<td>Output per worker 2</td>
<td>1.5</td>
<td>2.8</td>
<td>3.3</td>
</tr>
</tbody>
</table>

1 Business capital stock is built up from private purchases of plant and equipment, with allowance for retirements; excludes religious, educational, hospital, other institutional, and farm residential construction.

2 Business output is gross national product minus product originating in general government, government enterprises, households and institutions, the rest of the world, and services of existing houses.

Note.—Details of series are available upon request.

Source: Council of Economic Advisers.

Though there was no increase in capital per worker between 1929 and 1947, there was a slow increase in productivity which must be attributed to technical progress and to improvement in the quality of both labor and capital. When, as in subsequent years, investment was more rapid, there was an accompanying acceleration of productivity gains. These gains were not simply the result of the separate contributions of the advance of knowledge, the improved skills of the working population, and the rise in capital per worker, but came in large part from the interaction of all three.

Investment in new equipment serves as a vehicle for technological improvements and is perhaps the most important way in which laboratory discoveries become incorporated in the production process. Without their embodiment in new equipment, many new ideas would lie fallow. Conversely, the impact of a dollar’s investment on the quality of the capital stock depends on how rapidly increases in knowledge have taken place. This interaction between investment and technological change permits each worker to have not only more tools, but better tools as well.

The slower rate of growth of the capital stock in recent years provides one explanation for the accompanying slower growth of labor productivity and potential output. The proportion of output devoted to investment, and the rate of growth of the capital stock itself, are measures of the diversion of current resources to the creation of future capacity. During the period 1947–54, expenditures on business fixed investment averaged 11.0 percent of GNP and the stock grew at an annual rate of 4.2 percent (valued in 1961 prices). In the period 1955–60, 9.8 percent of GNP was invested and the capital stock grew at an annual rate of 3.2 percent. The ratio
of investment to potential GNP is even more relevant; in this case, the ratios are 10.9 percent and 9.4 percent for the two periods. This difference of 1.5 percent in the fraction of potential GNP invested represents nearly $45 billion of additional capital.

Policies to Encourage Investment

(1) Adequate levels of demand. The single most important stimulant to investment is the maintenance of full utilization of capacity. The historical record shows that when output falls below its potential the rate of growth of the capital stock declines. Expected profit from investment is strongly influenced by the expected demand for the output that the new capital will help produce, even if the investment is meant largely for cost reduction rather than capacity expansion. Estimates of future demand are colored by the experience of the present and the recent past. During periods of economic slack, estimates of future demand are relatively pessimistic, and many projects are foregone which would appear profitable under conditions of high demand.

There is a tendency to think of profitable investment opportunities for the whole economy as exhaustible: the more of them that are used up in any one year, the fewer remain. There may be some validity to this view for a single industry, which can mistakenly expand its capacity beyond the possibilities of future market demand. But for the entire economy, what appears as unavoidable excess capacity is in fact avoidable deficiency of demand. There are, and always will be, unsatisfied wants for a higher standard of living, though the demand for any particular product may perhaps be satiated. The investment boom of 1955–57 did not make inevitable the excess capacity that has ruled since then. Instead, it created an opportunity for higher levels of production in later years, had the demand been forthcoming. The opportunity was lost; even before the cyclical peak in the third quarter of 1957, the growth of demand slowed down and excess capacity began to emerge.

It is true that, with any given level of technology, a higher rate of investment can occur only through the acceptance of investment opportunities of lower profitability. But appropriate tax and monetary measures can make even these investments sufficiently attractive. And technical progress can have the same effect. To equip a more rapidly growing labor force also demands a larger volume of investment relative to potential GNP. Fortunately, if actual output is held close to a rising potential output, faster labor force growth will open opportunities for additions to plant and equipment which would be economically unattractive if the labor supply situation were tighter. Thus a higher ratio of investment to output can be more easily maintained. When excess capacity already exists, however, profitability is low for that reason alone, and the growing labor force appears as a threat, instead of the stimulus to investment it really is.
In addition to serving as an indicator of future profits, the level of aggregate demand, through its impact on current profits, plays an important role in providing finance for investment. The importance of the level of economic activity in determining profits is indicated in Chart 3, which shows that net and gross profits as a percentage of GNP fluctuate very closely with the rate of capacity utilization. A policy that sustains near-capacity operations goes beyond strengthening the profitability of investment; it insures an ample supply of low-cost internal funds, which itself encourages investment.

(2) Monetary and credit policy. The open market operations of the Federal Reserve and the debt-management operations of the Treasury exert a powerful influence on supply conditions in credit markets. If economic growth were the only end to be served, the sole object of monetary and credit policy would be to assure an adequate flow of funds to finance the needed capital formation at interest rates appropriate to the basic profitability of investment. This was pointed out by the Chairman of the Board of Governors of the Federal Reserve System in March 1961, in a statement to the Joint Economic Committee: “As I have said many times in the past, before this Committee and others, I am in favor of interest rates being as low as possible without stimulating inflation, because low rates can help to foster capital expenditures that, in turn, promote economic growth.”

Use of monetary techniques for growth purposes must, of course, be limited by the demands placed on them by other national objectives. In the present situation, for example, monetary policy has a role to play in the attainment of recovery from recession and in the restoration of balance of payments equilibrium. Policies for growth and recovery are complementary, since any policy that stimulates investment will simultaneously stimulate aggregate demand. This situation, however, will not always prevail. When excessive demand threatens inflation, stability and growth goals will tend to push monetary policy in opposite directions. At such times, the importance of economic growth would suggest the major use of other measures—principally budgetary surpluses—to achieve stability. For when demand is strong enough to generate pressure on existing capacity, and only then, rapid growth requires that enough resources be withheld from other uses to make a sustained high rate of investment possible without inflation. Under these circumstances, a surplus in the Federal budget plays the constructive role of adding to national saving and making resources available for investment. The role of a policy of monetary ease at full employment is then to insure that the resources freed by a tight fiscal policy are indeed used for investment and not wasted in unemployment.

The current balance of payments problem puts additional constraints on the use of monetary policy to promote recovery and growth. The techniques developed by the Federal Reserve to meet the new situation have already been discussed in Chapter 1, Part II.
(3) **Tax policy.** Every tax system is the product of particular needs and economic conditions; no tax system can be neutral in its effects on the ways in which households and business firms earn and spend their incomes. If faster economic growth is desired, revision of the tax structure is called for, to permit a higher rate of investment once full use of resources is achieved.

The Administration’s program encompasses two complementary approaches to this objective. The first is an investment tax credit equal to 8 percent of investment in eligible machinery and equipment; the second is revision of the guidelines for the tax lives of properties subject to depreciation.

The investment credit will stimulate investment by reducing the net cost of acquiring depreciable assets, thus increasing expected profitability. The increase will vary inversely with the expected life of the asset. For an asset with a service life of 10 years and an after-tax yield of 10 percent before the credit, the investment credit will increase the expected rate of return by about one-third. The increase in net yield will be greater for less durable equipment and smaller for more durable equipment.

Investment decisions are also influenced by the availability of funds. The investment tax credit will increase by some $1.5 billion the flow of cash available for investment under conditions anticipated for 1962.

Since the credit applies only to newly acquired assets, the entire incentive effect is concentrated on the profitability of new capital and no revenue is lost in raising the profitability of assets already held by business firms. It is an efficient way of encouraging re-equipment and modernization of productive facilities, as well as the expansion of capacity. The credit will thus help to accelerate economic growth and improve our competitive position. It will also increase the attractiveness of investment at home relative to direct investment abroad. In both ways the credit will help to ease our balance of payments problem.

Revision of tax lives for depreciable property is desirable as a matter of equity to reflect more accurately the influence of obsolescence on economic lives of capital assets. Present guidelines were established 20 years ago on the basis of replacement practices of the depressed prewar years. Depreciation, designed to reflect the loss in value of plant and equipment over time, is a function not alone of “wear and tear,” but also of technological progress, changes in the relative costs of economic inputs, competitive conditions, and consumer tastes and demand. Through its favorable effects on cash flows, expected rates of return, and risk, liberalized depreciation will tend to stimulate investment.

The investment tax credit, coupled with liberalized depreciation, will provide a strong and lasting stimulus to the high rate of investment that is a major requirement for accelerated economic growth. Together, they will provide incentives to invest comparable to those available in the rapidly growing industrial nations of the free world.
Attention to Federal income tax adjustments to stimulate investment must not be allowed to obscure the role of State and local tax policies and practices in economic growth. The tax collections of these governments are nearly half as large as Federal collections. In fiscal year 1960, they increased by more than 10 percent, or $3.7 billion.

The power to tax under this governmental system is shared by thousands of separate jurisdictions. Improved coordination among them will improve economic efficiency. Identical tax sources are frequently utilized by two, three, and even four layers of government without appropriate cooperation. Taxing authorities occasionally use their powers in ways that capriciously affect decisions concerning the location of plants and disrupt normal competition. The result may be a misallocation of resources and economic loss.

The Congress has recognized the need for better intergovernmental coordination. It has provided for the creation of the Advisory Commission on Intergovernmental Relations to foster "the fullest cooperation and coordination of activities between the levels of government." The Advisory Commission, composed of representatives of the executive and legislative branches of all levels of government, has already made important recommendations for the coordination of local taxes by the States and for improved tax coordination and cooperation between Federal and State governments.

INVESTMENT IN NATURAL RESOURCES

Economic growth is not simply a matter of growth in the size and skills of the labor force, in the quantity and quality of capital goods, and in the productivity of the processes by which these inputs are combined. It is equally a matter of turning more and more of the earth's endowment of natural wealth—soil, sunlight, air, water, minerals, plant and animal life—to the purposes of man. America's position has generally been one of natural plenty, but we cannot complacently assume that the abundance of the past will also characterize the future.

But neither is there any reason to suppose that resource limitations will in the foreseeable future place serious limits on the growth of the economy. Technological change, substitution of abundant and cheap raw materials for scarce and expensive ones, investment in improved resource management and conservation, and increased reliance on imports all provide important offsets to the effects of increasing scarcity on the real cost of obtaining resource inputs. Taken together, these factors tend to keep the economy growing along the path of least resistance so far as its resource requirements are concerned. If the various offsets to increasing scarcity are not fully effective, resources can be obtained by digging and drilling deeper, utilizing lower grade deposits, constructing dams and better waste treatment facilities, and other measures involving higher costs. But the necessity
to devote more labor and capital to these tasks would constitute a drag on the economy, tending to cancel some of the efforts we make to stimulate growth. Indeed, taking the economy as a whole, it is equivalent to a decline in productivity.

**The Historical Record**

A rough judgment as to the probable consequences of continued depletion of resources in the future can be derived by examining the record of the past. The long-term trend of raw materials prices relative to the prices of finished products is a useful, though by no means ideal, indicator of the effectiveness of the offsets to natural scarcity.

**Table 16.—Ratios of indexes of raw materials prices to index of finished products prices, 1900-57**

<table>
<thead>
<tr>
<th>Period</th>
<th>All raw materials ¹ ²</th>
<th>Agricultural products</th>
<th>Forest products</th>
<th>Minerals</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Total ²</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annual average:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1900-04</td>
<td>94</td>
<td>97</td>
<td>70</td>
<td>90</td>
</tr>
<tr>
<td>1905-09</td>
<td>96</td>
<td>103</td>
<td>77</td>
<td>81</td>
</tr>
<tr>
<td>1910-14</td>
<td>103</td>
<td>118</td>
<td>74</td>
<td>77</td>
</tr>
<tr>
<td>1915-19</td>
<td>108</td>
<td>121</td>
<td>74</td>
<td>87</td>
</tr>
<tr>
<td>1920-24</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>1925-30</td>
<td>112</td>
<td>122</td>
<td>94</td>
<td>94</td>
</tr>
<tr>
<td>1930-34</td>
<td>88</td>
<td>89</td>
<td>93</td>
<td>84</td>
</tr>
<tr>
<td>1935-39</td>
<td>102</td>
<td>104</td>
<td>109</td>
<td>94</td>
</tr>
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<td>1940-44</td>
<td>111</td>
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<td>127</td>
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<td>1945-49</td>
<td>125</td>
<td>134</td>
<td>158</td>
<td>93</td>
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<tr>
<td>1950-54</td>
<td>128</td>
<td>128</td>
<td>187</td>
<td>105</td>
</tr>
<tr>
<td>1955-57</td>
<td>118</td>
<td>105</td>
<td>154</td>
<td>111</td>
</tr>
<tr>
<td>1957</td>
<td>116</td>
<td>105</td>
<td>174</td>
<td>111</td>
</tr>
</tbody>
</table>

¹ Excludes fishery and wildlife products, for which adequate price data are not available.
² Excludes gold.

**Note:** Figures for earlier years, especially prior to 1915, are less reliable than those for later years. Annual index for each group has been divided by the over-all finished products index. Annual index for each group has been divided by the over-all finished products index.


Table 16 shows the movements of price indexes for all raw materials and for broad subgroups, relative to an index of prices of finished products. From 1900-04 to 1955-57—the last period for which data are available—the over-all index increased by 25½ percent, an average rate of increase just over 0.4 percent per year. The most striking feature of the table, however, is not this slow but visible trend toward increasing costs as our resource endowment has been exploited more intensively but the varying patterns of price movement shown by different commodities and by the same commodity at different times. The outstanding example of a strong upward price trend is forest products. Even in forestry, however, there are prelim-
inary indications that productivity gains are beginning to offset the effects of scarcity on prices. The index for all minerals has risen slightly less than that for all raw materials, and the subgroups of the minerals index show divergent movements. A considerably larger increase in the minerals index would undoubtedly have occurred if the opportunities of international trade had not been available. This is particularly true of the metals subgroup where net imports accounted for 44.8 percent of apparent consumption of metallic ores in 1957.

The index for agricultural products shows the effects of the great depression, the second World War and its aftermath, and the accelerated improvement of agricultural productivity in the 1950's. The last is largely responsible for the decline of the over-all index from its 1950–54 peak. It is reasonable to expect that improvements in agricultural productivity will continue to exert a substantial downward pressure on the over-all index in the future.

Implications for Public Policy

The lessons to be drawn from this review of past trends are these: First, it is likely that increasing resource scarcity has had only a negligible retarding effect on economic growth during the present century. Rising real costs of obtaining some resources have been largely compensated by declining costs of obtaining others. Second, the historical record does not indicate that more rapid economic growth will simply result in our "running out of resources" more quickly. On the contrary, past investments have permitted resources to be extracted more efficiently and used more efficiently.

Public policy has contributed to this success by limitation of economic waste, the development and adoption of improved methods in agriculture, forestry, and other fields, the unified development of river valleys, and a variety of other measures. Finally, the opportunity to obtain raw materials from abroad has been important in the past and will be increasingly important in the future.

Preventing resource scarcity from being a drag on economic growth is by no means the only objective of policy in this field. Particularly for water, forest, and scenic resources, an important objective is the provision of aesthetic and recreational benefits which are not reflected in aggregate measures of economic activity because they do not pass through the market place. The difficulty of determining objective standards by which such benefits can be weighed is obviously not a valid reason for neglecting them.

Water Resources

There is wide agreement that one of the most serious resource problems facing the United States at present and in the immediate future is the development of water resources. The use of water has been increasing rapidly as a result of population growth, higher living standards, increasing urbanization, rapid growth of industries that are heavy users of water,
increases in the amount of land under irrigation, and other factors. In the Eastern United States and the Pacific Northwest, the problem presented by these trends can be met for the next few decades by an adequate and appropriately timed program of investment in (1) multiple purpose water resource development which, in addition to other benefits, permits the collection and storage of water for use as needed and (2) facilities for treatment of industrial and municipal wastes. In some of the dry regions of the West, however, the opportunities for further development of water resources will be exhausted within the next two decades. Barring major scientific breakthroughs, the continued economic development of these regions will soon come to depend upon how effectively an almost fixed supply of water is used to satisfy the most important of the various industrial, agricultural, and municipal needs for water.

It is certain that additional investment to increase the quantity and to improve the quality of the supplies of water will be a major part of any solution to the problem. Pollution control, in particular, will require major investment expenditures in the coming decades. The enactment last year of the Administration's proposal for an expanded program of grants under the Federal Water Pollution Control Act and extension of Federal authority to seek abatement of pollution of navigable waters were important steps forward. But the fact that water resources in some regions of the country will soon be close to fully developed calls attention to a consideration that is relevant to water resources policy for the country as a whole: investment in development of existing water supplies is not a complete solution to the problem of water scarcity, nor is it necessarily the economically desirable solution under every particular set of circumstances. A variety of offsets to increasing scarcity are available and each has a role to play. In particular, additional research and development in methods of conserving and augmenting water supplies, including desalinization, weather modification, reduction of evaporation losses, cheaper and more effective waste treatment and more efficient use of water in industry and agriculture may produce high returns.

Since expensive investments must be undertaken to increase the quantity and quality of water supplies, it is appropriate that the costs be reflected in prices charged industrial and agricultural users. To treat a costly commodity as if it were free only encourages excessive use. There is evidence that significant reductions in water withdrawals could be achieved in many important water using activities and that they can be expected to occur if proper deterrents are provided. The burdens of scarcity on the economy cannot be entirely eliminated by using scarce capital to augment the supply of scarce water. But the burden can be minimized by a proper balance between investments in increased supply on the one hand, and price increases to eliminate inefficient use on the other.
Agricultural Land

The problem of agricultural land stands in sharp contrast to the problem of water resources. Whereas in the latter the problems requiring attention are those posed by increasing scarcity, in the former they are problems of adjusting to abundance.

Agriculture is the major source of downward pressure on the price index for all raw materials, and land is in ample supply. There are approximately 640 million acres of land suitable for cultivation in the United States at present, but only about 450 million are actually used for crops or pasture. Present indications are that only slightly more than 400 million acres of cropland (including cropland pastured and idle) will be in use by 1980 to produce agricultural products.

The major land resource investments required during the next several decades will, therefore, involve the conservation and protection of remaining farmland and the transfer of land to nonagricultural use rather than bringing more land into agricultural production. There are currently close to 70 million acres of land used for cropland which are subject to severe erosion hazard or otherwise not suitable for cultivation over the long run. Much of this land could be transferred to provide products or services, such as forestry and recreation, for which the demand is rising. At the same time, about 17 million of the 240 million acres of good land now in pasture or forest could be converted to cropland.

The Department of Agriculture currently has plans for a long-range land use adjustment program. This program has three major facets: transfer of cropland to grass; transfer of cropland to forest; and greater emphasis on wildlife and recreational development in the small watershed programs. As the program develops, it will be possible for supply management to place less emphasis on temporary diversion of acreage from the production of specific crops.

The present problems of U.S. agriculture, which reflect in part the fact that the pace of technological progress in agriculture exceeds the rate of growth in demand for farm products, should not blind us to the important lessons to be drawn from the record. When strong policy measures are taken well in advance, technological progress affords an escape from increasing scarcity. Indeed, it is technology that largely determines which portions of the environment are regarded as resources and which are not. Research not only makes possible the more effective use of existing resources, as in the case of agriculture, but may create important new ones. The record of agriculture also illustrates, however, the long lag between the decision to act and the appearance of the benefits. Careful and continuing analysis of present and future resource needs, coupled with readiness to act when the indications of potential difficulties become persuasive, is the best hope for success in meeting the resource requirements of rapid economic growth.
INVESTMENT IN PUBLIC SERVICES

Accelerated economic growth will require increased public investment, just as it will require increased private investment. Without additional plant and equipment, governments at all levels will be unable to meet the increased demands for public services that arise both as a consequence of measures taken to stimulate growth and as a consequence of growth itself. If a high and rising educational level of the labor force is sought as a means to speed economic growth, additional investment in school and college buildings, furnishings, and laboratory equipment will be required. Demands for transportation of both people and goods will increase as a result of economic growth; meeting these demands will require additional investment in urban public transportation systems, airports, roads and highways.

Failure to make adequate investments in the physical basis of public services inevitably retards economic growth. In some cases, the connection is fairly easy to trace; inadequate investment in highways will bring an increase in congestion, with consequent declines in the productivity of trucks and truck drivers, and rising transportation costs. In other cases, the process by which a shortage of basic public services tends to retard the growth of output is less obvious, but no less real; education is an important example. As has been noted above, an inadequate effort to solve the water pollution problem will be paid for in higher costs of obtaining water of adequate quality—unless it is paid for by a decline in the health of the population and decreased productivity in water-using industrial processes. Inadequacy of public services also has effects on economic welfare that are not reflected in aggregate economic statistics. Commuters are well aware of the sacrifice of time that results from inadequate urban transportation systems. The sacrifice of recreational opportunities resulting from failure to make sufficient provisions for public parks as cities expand is another example.

The task of meeting the transportation, recreation, education, housing, and other needs of growing metropolitan areas poses a major challenge to our existing forms of political organization at the State and local level. Public facilities serving the needs of individual political jurisdictions within an urban area are often less efficient than they would be if they had been designed for all, or a large part, of the area. For example, lack of effective and well coordinated land use planning and zoning regulation has resulted in locational patterns of residential, commercial, and industrial developments that intensify transportation problems. Improved planning and coordination can increase the efficiency of public services and make cities better places in which to live. Progress can be achieved through continued Federal assistance to States and local bodies for the planning of urban area development, comprehensive urban renewal programs within cities, public improvement programs, and specific public improvements.
Although the Federal Government is making an important contribution to the solution of problems whose significance extends beyond the boundaries of political units at lower levels, it must be remembered that civil government is basically a State and local responsibility. About 80 percent of spending for civil government in 1960—for education, highways, water supply, sanitation, public health, police and fire protection, etc.—actually took place at the State and local level, with only about 15 percent of these local expenditures financed by Federal aid. State and local governments account for more than 70 percent of public civilian employment and for two-thirds of nonmilitary government payrolls. Their activities are a major factor in the economy.

As a Nation, we have surely not erred on the side of excessive public investment in recent years. Major sources of demand for public services have expanded sharply: for example, the number of automobiles and trucks has grown more rapidly than GNP, and the extent of urbanization has increased. Nevertheless, new nondefense public construction as a fraction of GNP was essentially unchanged in the 1950's from its level in the 1920's. It must also be noted that a substantial backlog of unsatisfied needs for schools, highways, and other public facilities was carried over into the decade of the 1950's from the second World War—probably a much greater backlog than was carried into the 1920's from the first.

Although these historical comparisons throw an interesting light on the changing role of the public sector in the U.S. economy, they do not provide firm standards for the future division of responsibility between the public and private sectors. That issue cannot be settled by the invocation of historical ratios any more than it should be settled by abstract argument. If our economy is to use its productive resources in reasonable accordance with a consensus as to national priorities, we must face the question of public versus private expenditures pragmatically, in terms of intrinsic merits and costs, not in terms of fixed preconceptions.

**Investment in Housing**

The higher standard of living made possible by economic growth results from increased output of a wide variety of goods and services. Among these is one item which, by virtue of its economic importance, its great influence on the general quality of life, and the unique character of the capital investment required to expand its supply, deserves special attention in a discussion of economic growth. This item is housing.

The value of the current services supplied by the Nation's residential structures—the total of rents paid plus the imputed rental value of owner-occupied dwellings—accounted for 13.1 percent of personal consumption expenditures in 1961, or 8.5 percent of GNP. Another 4.1 percent of GNP was accounted for by residential nonfarm construction—the total expenditures on replacing, improving, and adding to the nonfarm portion of the stock of residential structures. That stock itself represents roughly
one-fourth of our national wealth, about twice the share accounted for by producers' durable equipment.

These figures are, in part, a statistical image of the importance of the basic human need for shelter. To a greater extent, however, they reflect the fact that better housing is among the most important benefits that economic progress can confer. A dwelling that provides adequate protection against the elements may nevertheless be a serious hazard to the mental and physical health of its occupants, if it is overcrowded, lacking in hot and cold running water or plumbing facilities, or structurally unsound. A better home provides a healthier, safer, and more comfortable living environment; it affords greater opportunities for recreation, aesthetic enjoyment, and peace and quiet.

Few, if any, Americans actually lack a roof over their heads. But about one-fifth of the Nation's housing units are classified as "dilapidated" or else lack one or more of the basic plumbing facilities. Like the poverty that it reflects, substandard housing is a burden borne to a disproportionate extent by a few groups in the society; the aged, the nonwhite, the poorly educated, and families without a male breadwinner. The burden is perhaps most regrettable when it renders ineffective the measures society takes to promote equality of opportunity. The child who has no decent place in which to study can hardly take full advantage of the free education that is provided to him.

The elimination of substandard housing and the provision of a decent home in a suitable environment for all American families is an important objective of public policy in the housing field. The public interest has been deemed to extend also to the promotion of home ownership. Through the mortgage insurance and mortgage guaranty operations of the Federal Housing Administration (FHA) and the Veterans Administration (VA) and the secondary market operations of the Federal National Mortgage Association (FNMA), the Government facilitates homebuilding and the flow of private capital into home loans by providing insurance against the risk of default and making mortgage loans a more liquid investment for financial institutions. In addition, FNMA assists in the financing of certain special types of home mortgages, as authorized by the Congress and directed by the President. Public housing amounted to just over 3 percent of all nonfarm housing starts between 1947 and 1960.

These various activities played a major role in the substantial progress toward better housing for the Nation that was made during the 1950's. Whereas in 1950, 55.0 percent of occupied housing units were owner-occupied, 61.9 percent were owner-occupied in 1960. Nonfarm housing starts exceeded the increase in the number of nonfarm households by roughly 25 percent for the decade, providing a margin for replacement of housing units demolished by public and private improvement programs, for improvement of average quality, and to accommodate housing needs arising from migration and mobility of the American people. In recent years, about
30 percent of sales of new nonfarm housing units have been under the FHA or VA programs.

A sharp rise in the rate of household formation will occur in the latter part of this decade, reflecting the high birth rates of the middle and late 1940's. It is all the more important, therefore, that substantial progress in improving the average quality of the Nation's housing be made in the early part of the decade, when the need to increase its quantity will be less urgent. The enactment in the last session of Congress of the Administration-sponsored Housing Act of 1961 was a major step toward meeting the Nation's housing needs. In addition to extending and expanding existing programs for public housing, housing for the elderly, college housing, and farm housing, the Act provides for major new programs of FHA-insured loans to finance construction and rehabilitation of housing for moderate income families, and long-term FHA-insured home repair loans. These new types of loans are eligible for purchase by FNMA. Other important provisions make Federal assistance available to States and localities for various measures in the field of urban affairs, including planning, loans, and demonstration grants for mass transportation projects, and acquisition of land for permanent open-space uses, such as parks. Additional funds were authorized to finance the construction of community facilities. Finally, a series of provisions make additional assistance available for households and businesses displaced by urban renewal programs or other government actions.

Rapid economic growth should bring the national goal of decent housing and a suitable living environment for every American family well within reach during the present decade. Estimates prepared for the Council of Economic Advisers by the Housing and Home Finance Agency indicate that no American households need occupy a dilapidated structure by 1970. This could be achieved with about the present ratio of residential construction expenditures to GNP—provided that GNP itself grows at approximately the rate discussed earlier in this chapter. This estimate includes an allowance for expenditures on additions and alterations based on extrapolation of the 1950–60 trend, but this allowance is probably not adequate to make possible the elimination of housing that is deficient for reasons other than dilapidation. It is clear, however, that the virtually complete elimination of deficient housing is by no means an unrealistic objective in a context of rapid economic growth.

Construction costs have risen more rapidly than broad price indexes in recent years. For example, while the all-inclusive price index for GNP rose by 40 percent between 1947 and 1961, the subindex for nonfarm residential construction rose by 50 percent. If this were to continue, it would mean that the share of current-price GNP devoted to the building of houses must rise if the proportion of real output going into housing investment is not to fall. There is a need to identify artificial barriers to technological progress and to efficient allocation of resources in the construction industry. Their
reduction or removal can make a significant contribution to growth in this important sector of the economy.

CONCLUSION

This Chapter began with the observation that sustained long-run growth of potential supply is both difficult to achieve and pointless of achievement unless the growth of demand keeps pace. Capacity to produce is not an end in itself, but an instrument for the satisfaction of needs and the discharge of responsibilities. The needs will go unfilled and the responsibilities unmet to the extent that growing productive power runs to waste in idle machines and unemployed men.

Here the objectives of stabilization policy and growth policy coalesce. The mandate of the Employment Act renews itself perpetually as maximum levels of production, employment and purchasing power rise through time. The weapons of stabilization policy—the budget, the tax system, control of the supply of money and credit—must be aimed anew, for their target is moving. In particular, as Part II of Chapter 1 explains, with given expenditures and given tax rates, the Federal budget surplus at full employment grows with the economy. If it grows too rapidly, it can become an obstacle to full employment, to healthy economic growth, indeed to its own realization. If it grows too slowly, it can contribute to inflationary pressure.

Some surplus at full employment may be desirable, to help to finance the formation of capital. How large it should be depends on the size of the investment program required by the economy, on the freely made saving decisions of families and business firms, and on the level of government expenditures. It is the function of monetary policy, the tax system, and transfer payments to help to generate demand for the investment needed for economic growth. It is the function of over-all fiscal policy to insure that investment demand is matched, at full employment, by an equivalent volume of private and public saving.

The course of the budget surplus at full employment depends on the growth of the national income, the responsiveness of tax revenues to a rising tax base, and the changing level of Federal outlays. Even if Federal expenditures remain a constant proportion of GNP, as they have in recent years, the surplus at full employment will grow slightly because the progressive character of the tax system causes revenues to rise relative to GNP. If expenditures remain constant, or nearly so, the full employment surplus will grow much more rapidly.

As the economy returns to the full employment track, the full employment surplus will need to be kept from growing indefinitely, and perhaps to be reduced. The choice—or rather the division, for it is unlikely to be an “either-or” matter—is between reductions in tax receipts and increases in government expenditures, whether Federal, State or local. A pragmatic decision will almost certainly involve both. It is unlikely that the most
urgent unmet needs of the population will lie all in the area of private consumption or all in the areas traditionally allotted to public consumption and investment. Undoubtedly much of the reduction in the full employment surplus should be channeled directly to private purchasing power, just as most, by far, of present consumption spending is in private hands. The choice of a balance between public and private expenditures is an important choice for society. It should be made consciously through the normal democratic processes. And it should be made by weighing the urgency of alternative uses of resources, rather than by appeal to simple slogans on one side or the other.

The concern of this chapter has been the source of rising productive potential and the policies that can strengthen them. Granted continued prosperity, we can have slower growth or faster growth. There is substitution between the composition of output in the present and the level of output in the future. Just as a single individual can increase his consumption possibilities in the future by present saving, so can a whole society provide more fully for its future by using present resources for acts of investment in the broadest sense. No absolute reduction in current consumption need occur; it is only necessary that consumption grow less rapidly than total output for a time. Indeed, future levels of consumption will be higher than they could otherwise be—the cost is primarily in postponement. Happily, for an advanced society like ours, much of what is described from this point of view as investment can also be seen as present enjoyment of some of the delights of civilization: widespread education, good health, and the search for knowledge.
Chapter 3

The Balance of International Payments

The recovery and growth of the U.S. economy are not important for the United States alone. On the vigor of our economy depend in large measure the strength and stamina of the free world and the standing of freedom in the minds of men everywhere. Leadership in the world requires the support of a growing and dynamic domestic economy, using to the full its vast productive capacity. The other nations of the free world rely heavily on the United States as a market for their products and as a source of capital and technology for their economic growth. The United States has taken the lead in meeting the responsibilities of the advanced countries to foster the economic development of the low-income nations. The less developed countries need both public and private investment capital; they need full opportunity to sell their products in world markets in order to earn the industrial imports that their development programs require; and they need a democratic alternative to the communist prescription for economic development.

The U.S. balance of international payments is the outcome of countless separate transactions by governments, private businesses, and individuals. The obligations of world leadership entail large government outlays abroad. U.S. business firms and consumers pay out billions of dollars for foreign goods and services. U.S. corporations, financial institutions, and individuals acquire properties, buy securities, and lend money abroad. The United States is one of a very few countries with a long standing policy permitting residents and foreigners complete freedom to make payments abroad in its currency. For many years, the United States had little reason to be concerned whether all these payments were covered by corresponding receipts from abroad. Foreign demands for U.S. goods and services were large; the dollar was, and still is, a ticket of entry to the world's largest and most diversified market. In some periods, the surplus of receipts was so large that the United States took actions to moderate its effects both at home and abroad. And if international payments happened to exceed receipts in any year, foreigners were willing to hold most of the dollars they acquired; only a small part of the deficit had to be met from our large gold reserves.

Recently, persistent payments deficits and gold losses have made it necessary for the U.S. Government to give greater attention to the net financial outcome of its transactions, and those of its citizens, with the rest of the world. Payments need not and should not be directly controlled, but the
balance must be under control. Many private international transactions depend in large part on economic circumstances at home. Consequently, domestic economic policy must be framed with an eye to the balance of payments. Action to safeguard the international position of the dollar is today an essential part of policy for full employment and growth.

The policies adopted in 1961 to strengthen the balance of payments are already beginning to take effect. The deficit in the international payments of the United States, which had averaged $3.7 billion annually in each of the three preceding years, was less than $2.5 billion in 1961, according to preliminary estimates. Gold reserves declined by less than $0.9 billion in 1961, compared with $1.7 billion in 1960. The full effects of measures under way and proposed will in time restore a sustainable balance in U.S. transactions with the rest of the world.

This chapter examines first the background for policies to improve the balance of payments and safeguard the position of the dollar: the general objectives which guide U.S. international economic and financial policies; the trading, investing, and international banking functions of the United States and their interrelations; and recent changes in the world economy affecting the U.S. balance of payments. In the final sections of the chapter, policies that are under way and proposed are discussed: measures to balance the basic international accounts; measures to limit disruptive flows of short-term capital; and measures to strengthen the international monetary system.

THE UNITED STATES IN THE WORLD ECONOMY

Objectives of U.S. Foreign Economic Policy

A basic objective of U.S. policy is to provide an economic environment in which the people of the United States and of all nations can steadily raise their standards of living. Economic growth at home will support, and will be supported by, progress and development abroad, provided that international cooperation and commerce distribute equitably and efficiently the fruits of productive specialization among all free nations. International financial arrangements and policies are means to this fundamental end. A stable and efficient system of international payments is essential to facilitate desirable international flows of goods, services, and capital. The dollar has become the principal international currency, and the stability of the dollar is the foundation of the international payments system which has evolved since the war. For this reason, the President has declared that the present gold value of the dollar will be maintained. To safeguard the stability of the dollar, the United States is determined to improve its balance of international payments.

Postwar progress. U.S. foreign economic policy since the war has sought to build an international economic environment in which goods, services, and capital flow freely across national boundaries. This policy has been based on
the conviction that a free exchange of products and capital in worldwide markets will raise standards of living both in the United States and in the rest of the world. The example of the vast continental market of the United States attests to the economic gains afforded by geographical specialization and exchange and by the mobilization of savings in one region to finance productive investment opportunities in another. Without this huge internal market, unhampered by trade restrictions between States, American standards of living could not have risen to their present heights. Throughout the world, similarly dramatic gains can be achieved by international specialization and trade.

The framework of international economic cooperation in the free world today, especially among the industrial countries, represents a notable achievement. The great depression and the war left a legacy of national restrictions on movements of goods and capital—exchange controls, quantitative restrictions on imports, bilateral clearing and trading arrangements, discrimination against dollar goods. Since the war, the countries of the free world have been engaged in clearing away this restrictive legacy. Even before the war ended, the foundations were laid for the International Monetary Fund, the International Bank for Reconstruction and Development, and the General Agreement on Tariffs and Trade. The United States provided aid and leadership in European economic reconstruction and trade liberalization through the Marshall Plan and through association with the Organization for European Economic Cooperation. Substantial progress has been made toward a world of currencies convertible at fixed exchange rates and toward freedom from direct and discriminatory controls over trade and payments. Progress has also been made, though less rapidly, toward a world of lower tariff barriers; here is an opportunity for a major step forward.

Expanding trade: a new program. Foreign trade is not so vital to the United States as it is to most other countries. But the contributions of trade to our domestic welfare are nonetheless real and important. Net foreign purchases of our products contribute to output, employment, and economic growth in the United States. More significant, the opportunity to sell our products abroad in exchange for foreign goods enables us to specialize the structure of our production and to diversify the patterns of our consumption. By specializing in the production and export of goods in which the United States is unexcelled, Americans are enabled to import goods which would be impossible or costly to produce at home. Foreign trade raises living standards by widening the choice of goods available to the American consumer and by providing him with some goods and services at lower prices.

As other countries have recovered from the devastation of war and have rebuilt and modernized their productive capacity, they have become increasingly vigorous competitors of the United States in world markets. The most notable new source of competition is the European Economic Community, or Common Market, which now includes France, Germany, Italy,
Belgium, Holland, and Luxembourg, and which shortly may include the United Kingdom and several other European countries. Members of the Common Market are committed to the rapid elimination of tariffs among themselves and the establishment of a common external tariff on imports from the rest of the world.

Still in its formative years, the Common Market has imparted amazing vitality to the economies of its members. U.S. exports to Western Europe have risen sharply in response to the rapid economic growth within the Common Market countries. We cannot be sure that this rise in exports will continue unless we can negotiate substantial reductions of the Common Market’s external tariff. The evolution and enlargement of the Common Market inevitably increases tariff discrimination against U.S. exports; we must compete over this tariff barrier while members of the Common Market have steadily freer access to each other’s markets.

The Administration is therefore proposing to the Congress a major revision in foreign trade policy. The President’s current authority to negotiate tariff reductions has been virtually exhausted. For the first time since the original Trade Agreements Act was passed in 1934, Congress is being asked to equip the President with new kinds of bargaining instruments for negotiating with the Common Market. We must assure access of the products of our farms and factories to the world’s largest market outside our own. Successful negotiations will make possible increasing specialization of production in both Atlantic markets. It will also make it possible to offer the free nations of other continents greater access to markets on both sides of the Atlantic.

Safeguarding the dollar. A stable and efficient system of international payments is an integral part of the liberal international economic environment toward which the free world has been moving. Uncertainties about the value and convertibility of the proceeds of international transactions disrupt movements of goods, services, and capital between nations. Convertible currencies and stable exchange rates as envisaged in the Bretton Woods agreements provide assurance of the value of international claims acquired by trade or investment.

The United States performs a special world banking function in the present international payments system. The dollar, alone with the pound sterling among national currencies, has come to be used as a major international currency by the free world. Private traders, banks, and governments have chosen to use dollars both as a means of payment and as a store of value. Foreign countries hold liquid dollar balances, acquired in international transactions, in much the same way that individual depositors hold balances in commercial banks. Foreign governments and central banks accept dollars as a partial substitute for gold in their international reserves because the dollar is an international currency and because the policy of the U.S. Treasury is to sell gold on demand to foreign governments and monetary authorities at a fixed price. The dollar became a “reserve currency” without any conscious international decision to establish a payments system.

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based on key national currencies. Use of the dollar as a reserve currency has met growing needs for international reserves and economized the limited and slowly growing supply of gold.

Foreign central banks and governments hold as part of their international reserves $11 billion of short-term dollar obligations, which can be used to purchase gold from the United States. In addition, foreign private short-term dollar holdings amount to $8 billion. Whenever dollars held by foreign private banks or individuals, or dollars held by U.S. residents themselves, are sold to foreign central banks for other currencies, they become potential claims on our gold stock.

Because of the strategic role of the dollar, maintenance of its established gold value is essential to the stability and efficiency of the present system of international payments. Accordingly, when the President pledged that the gold value of the dollar would be maintained, he stated that “the full strength of our total gold stock and other international reserves stands behind the value of the dollar for use if needed.” This reserve strength comprises $17 billion in gold (two-fifths of the monetary gold stock of the free world), small amounts of convertible foreign currencies, and drawing rights on the International Monetary Fund (IMF), of which $1.7 billion is automatically available under current practices of the Fund. An additional $4.1 billion could become available in accordance with Fund policies, insofar as the Fund has available resources in gold and usable foreign currencies. The recent agreement to strengthen the IMF (discussed at the end of this chapter) should do much to assure the availability of such resources.

Reducing the deficit. Deficits in the U.S. balance of payments are financed either by drawing down our gold reserves or by increasing the potential foreign claims against them in the form of liquid dollar liabilities to foreigners, official and private. Large and continuing deficits cannot be financed indefinitely. U.S. reserves, although very large, are not inexhaustible. Foreigners have accumulated large liquid dollar balances, but they will not be willing to let these balances grow without limit.

Therefore, the policy of the U.S. Government, as stated by the President in his message to Congress of February 6, 1961, is to “gain control of our balance of payments position so that we can achieve over-all equilibrium in our international payments. This means that any sustained future outflow of dollars into the monetary reserves of other countries should come about only as a result of considered judgments as to the appropriate needs for dollar reserves.”

Maintaining basic objectives. These related tasks—maintaining the external value of the dollar and bringing our international accounts into balance—must be accomplished by means which promote the basic national objectives from which the tasks derive. To balance our accounts by restrictions on trade and capital movements, for example, would confuse means and ends. Such restrictions would violate the fundamental principles
of international economic relations for which our policy has striven for
many years with so much success. Similarly, the foreign policy of the
United States calls for large loans and grants to foreign countries for de-
velopment and for defense; and the maintenance of our military establish-
ment abroad entails substantial overseas expenditures. To curtail the sub-
estance of these programs would provide no solution to the "dollar problem." Rather, the task of balance of payments policy is to find the foreign exchange
resources necessary to finance them. Finally, full recovery and economic
growth, primary national goals in themselves, are also essential elements
in the long-run capacity of the United States to meet its international com-
mitments and responsibilities. Measures to rectify the balance of payments
must be consistent with expansion of the U.S. economy.

The United States as Trader, Investor, and Banker

The accounts. The U.S. balance of international payments over the last
decade is shown in Table 17. In the table, international transactions are
classified into four accounts: (1) current account and unilateral transfers,
encompassing merchandise trade, earnings on U.S. foreign investments less
foreign earnings on investments in the United States, services including
tourism and ocean freight, private remittances, and government military
expenditures and development grants; (2) long-term capital account, cover-
ing direct investments in business enterprise abroad, private purchases of foreign securities, U.S. Government loans, and long-term investments by foreigners in the United States; (3) short-term capital account, including commercial credits under one year and U.S. purchases of foreign short-term securities; (4) over-all balance, comprising net purchases of monetary gold and convertible currencies plus decreases in U.S. liquid liabilities to foreigners.

The accounts are, of course, far more interrelated than a simple classification of transactions suggests; foreign aid, private direct investment, and private remittances often consist in shipment abroad of U.S. goods. Even dollar outflows which are not so closely linked to the purchase of U.S. goods and services frequently result in reverse payments to the United States, either directly from the immediate recipient or indirectly through transactions involving third countries. The volume of our exports and indeed the size of the trade surplus are thus not independent of the size of our government outlays and private investments overseas.

The first account covers international transactions which relate to the earning and spending of national income. A surplus in this account means that the Nation as a whole is earning more than it is spending in its relations with the rest of the world, and this “saving” leads to an increase in the net assets of the country. Throughout the period covered by the table, the United States had a substantial merchandise trade surplus which, with other current receipts, was usually enough to pay for large overseas military expenditures and government grants for foreign reconstruction and development. In the first three quarters of 1961, the surplus on current account and unilateral transfers was at an annual rate of $2.4 billion.

The second account summarizes the transactions of the United States as an investing nation. In recent years the United States, as Table 17 shows, has invested in long-term foreign assets more than its surplus on current account and unilateral transfers. It has also lent to foreigners substantial amounts of short-term capital, as the third account in the table shows. The excess of our long-term investment and short-term lending over our surplus on current account and unilateral transfers—the over-all deficit—has been financed by increasing our liquid liabilities to foreigners and by selling gold.

The present payments problem of the United States is not one of solvency. The Nation is not “living beyond its means”; rather, its means are steadily increasing. At the end of 1960, the U.S. Government owned foreign assets totaling $21 billion, in addition to its gold holdings of $18 billion; and U.S. citizens owned another $50 billion in assets abroad (Table 18). In total, U.S. net claims on foreigners (including reinvested subsidiary earnings on investments abroad) rose by $4 billion in 1960, and the increase was perhaps as much in 1961. These increases substantially exceeded our losses of gold. Our foreign assets give basic long-run strength to the dollar; but because most of these assets are either privately owned or long-term investments or both, they cannot be quickly mobilized.
It is useful to distinguish net payments resulting from merchandise trade, services, unilateral transfers, and long-term investment—the so-called basic accounts—from net payments resulting from the more volatile, and sometimes substantial, flows of short-term capital. The balance on basic accounts and the over-all balance are shown in Table 17 and Chart 11. In 1959 the "basic" deficit was larger than the over-all deficit because of net inflows of short-term capital, while in 1960 and again in 1961 the over-all deficit exceeded the deficit on basic accounts as a result of net outflows of short-term capital.

The over-all balance exerts a significant influence on the liquidity position of the United States. The change in the U.S. position resulting from overall deficits in the past decade can be seen from the reduction in the monetary gold stock and the increase in U.S. liquid liabilities to foreigners, shown in Table 18 and Chart 12.

Reserves and liquid liabilities. In 1949, the United States held 70 percent of the world monetary gold stock and half of the world total of official gold and foreign exchange reserves. Capital seeking haven from the political disruptions of the 1930's, followed by the import needs of war-torn Europe, produced this undue concentration of world reserves. In those
In your circumstances, deficits in the U.S. balance of payments served the very useful function of rebuilding the depleted reserves of other countries. Countries chose to replenish reserves largely by holding dollars rather than by purchasing gold. While cumulative deficits totaled $23 billion in the past 12 years (Chart 12), U.S. gold sales amounted to just $7 billion, of which $5 billion represented reacquisition of gold that the United States had obtained in the early postwar period. The rest of the deficit was settled by an increase in foreign dollar holdings.

Despite the continuous rise in foreign dollar holdings, the liquidity position of the United States is strong. The importance of the United States in international trade and international banking, the facilities offered by the New York money market, and the variety and quality of goods, services, and securities which dollars command within the United States make it advantageous for foreigners to hold large dollar balances. These working balances will not readily be withdrawn, although they are not entirely insensitive to yield opportunities abroad. Furthermore, as world trade expands, the size of these working balances is likely to rise.

The present position of the United States is satisfactory as long as foreign holders of dollars are confident that the gold value of the currency will be maintained. Loss of confidence can, however, result in a serious “run.” Indeed—as the failures of basically sound and solvent com-
mercial banks before the days of deposit insurance testify—there is no conceivable liquidity position which can withstand general loss of confidence.

Payments deficits and gold losses. As U.S. experience in the past 12 years indicates, there is only a loose link between external deficits and gold losses. Deficits occur when total payments to foreigners exceed total receipts from foreigners; a decline in gold reserves occurs when a foreign government or central bank converts dollars into gold at the U.S. Treasury. A deficit in the balance of payments need not, and usually does not, coincide with an equal decline in gold reserves. Foreigners may increase their dollar holdings by part or all of the deficit—or, as happened in 1956, even by more than the deficit (Chart 12). Similarly, this country may lose gold even when it has a balance of payments surplus, if foreign official institutions wish to convert dollars acquired in the past.

Payments deficits contribute indirectly to gold losses by adding to the supply of dollars in foreign hands, thus increasing the likelihood that they will be acquired by governments which may wish to convert them into gold. Moreover, the fact that there are persistent payments deficits may reduce foreigners' willingness to hold dollars.

Three years of large payments deficits contributed to a temporary decline in confidence in the dollar and to the large gold sales of late 1960. An outflow of short-term funds began in mid-1960 as a normal response to higher interest rates abroad, but it was augmented when doubts arose about the stability of the dollar, as evidenced by substantial private purchases of gold on the London market. These doubts reflected a number of factors: the large payments deficits of 1958 and 1959 and the loss of gold associated with them, the outflow of funds early in 1960 associated with differentials in interest rates, the initial rise in the London gold price, and fears that strong action to defend the dollar would not be taken. Confidence was restored when the new Administration declared and demonstrated its determination to defend the dollar, intensified measures taken by the previous Administration to reduce the payments deficit, and inaugurated new measures.

Recent Developments Affecting the U.S. Payments Position

Although the United States has been running deficits in its international accounts since 1950, these deficits were moderate in amount and did not cause concern until 1958. Concern has arisen since then, partly because of the unexpected persistence of large deficits and partly because the deficits could not be attributed to temporary developments likely to be soon reversed. Several significant new factors changed the U.S. position in the world economy: (1) The establishment of external currency convertibility by most of the European countries at the end of 1958 removed an important barrier to international capital flows. (2) The establishment of the European Economic Community promised a large, rapidly growing, tariff-free market in Europe, holding out much the same investment opportunities as the
CHART 12

Changes in U. S. Gold Stock and Liquid Liabilities to Foreigners
(Annual and Cumulative)

BILLIONS OF DOLLARS

ANNUAL

CHANGE IN GOLD STOCK

OVER-ALL BALANCE

INCREASE IN LIQUID LIABILITIES


BILLIONS OF DOLLARS

CUMULATIVE DEFICIT, END OF YEAR

TOTAL INCREASE IN LIQUID LIABILITIES SINCE 1949

TOTAL GOLD LOSS SINCE 1949


*FIRST 3 QUARTERS.

SOURCES: DEPARTMENT OF COMMERCE, TREASURY DEPARTMENT, AND BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

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tariff-free internal market of the United States. (3) Intercontinental ballistic missiles and restoration of political stability in Western Europe reduced the special attractions of the United States as a haven for funds and as a location for capital investment. (4) The large overseas military expenditures and extensive foreign aid programs of the United States came to be clearly recognized as long-term commitments. (5) The decline of the U.S. trade surplus, from $6 billion in 1957 to a postwar low of $1 billion in 1959, focused attention on the long-run improvement in the competitive position of Western European countries and Japan relative to the United States—an improvement caused mainly by remarkable advances in output and productivity in those countries. (6) In addition, a sharp rise in certain key prices in the United States relative to those of major competitors weakened the competitiveness of some U.S. products in world markets. (This development is described in Chapter 4.) (7) By 1958, gold and foreign exchange reserves of many European countries had been rebuilt from their depleted postwar levels; U.S. payments deficits were no longer needed for this purpose.

These developments occurred within a short span of years and affected not only the U.S. payments position itself but attitudes and expectations about its future. The U.S. economy, which was geared to the entirely different environment of the years of “dollar shortage,” suddenly had to adjust to a new situation. In brief, the required readjustment is that the United States must pay for overseas military commitments, grants, and investments to a greater extent by an export surplus earned in stiff world competition, and to a lesser extent by selling gold and accumulating liquid liabilities to foreigners. For the domestic economy, this implies changes in the structure of prices, wages, investment, and employment and a new orientation of American enterprise to world markets. A complete readjustment of this nature takes time.

Policies To Improve the U.S. Payments Position

In the new environment of the 1960’s, the United States cannot continue deficits of the size of the late 1950’s. The balance of payments objective for the United States is to attain, at high employment levels, a balanced position in its basic international accounts during the next few years. We must move toward equilibrium at a pace which demonstrates clearly that the balance of payments is under control.

The objective of a balanced basic position does not mean that balance must be maintained continuously. In some years, a surplus in international payments will be appropriate; in other years, a deficit. But the average position over a period of years must be strong enough to maintain confidence in the parity of the dollar.

The primary task is to improve the position of the basic accounts. Progress toward balance in these accounts will itself diminish the likelihood of sustained short-term capital outflows. Therefore, in a discussion of pros-
pects and policies for improving the balance of payments position, it is con-
venient to discuss, first, the basic accounts, and then the short-term capital
account.

Basic Accounts

The underlying trend of the basic accounts position is not easy to discern
from current quarterly and yearly statistics. It is difficult to disentangle
movements of lasting significance from changes resulting from seasonal,
cyclical, and random factors. When, in the first half of 1961, slack in the
U.S. economy combined with boom conditions in Europe and Japan to
bring our basic accounts into temporary surplus, it would have been
clearly wrong to conclude that the problem was permanently solved. Con-
versely, subsequent reappearance of a deficit on basic accounts, which may
even rise temporarily as recovery proceeds in the United States, reflects a
reversal of cyclical influences rather than a deterioration in the underly-
ing position. Long-run improvement resulting from competitive adjust-
ments and government policies may be masked by temporary developments
here and abroad.

The dimensions of the problem facing the United States may be indicated
by the basic international accounts in the six-month period embracing the
second and third quarters of 1961—the latest 6 months for which complete
information is available—expressed in terms of annual rates (Table 19).
Overseas military expenditures, less foreign military purchases in this
country, were running at $2.4 billion in mid-1961. Government grants
and loans amounted to $3.7 billion, but $2.5 billion of these resulted
directly in the export of U.S. goods and services, leaving $1.2 billion to be
otherwise financed. Long-term private investment abroad was running at
about $2.0 billion, and pensions and remittances to foreigners cost nearly
$900 million.

The overseas commitments and investments, resulting in payments of
$6.4 billion (2.4 + 1.2 + 2.0 + 0.9, rounded), must somehow be financed by
net receipts from other transactions. This requirement was partially met by
debt repayments by foreign governments (excluding special prepayments in
April) and net earnings on services (excluding military transactions and
receipts associated with government aid) amounting to $2.2 billion at an
annual rate. Full balance in the basic accounts would, therefore, have re-
quired a merchandise trade surplus (excluding exports financed directly by
government grants and loans) of $4.2 billion. This contrasts with the trade
surplus of $2.8 billion actually achieved. The resulting deficit of $1.4
billion had to be financed by a sale of gold and an increase in our liquid
liabilities to foreigners.

Without temporary cyclical factors, the gap would probably somewhat
exceed the deficit of $1.4 billion on basic accounts actually experienced
during this period, since our gross national product (GNP) was still far
below full employment levels. At full employment, imports can be expected
to be higher than they were in mid-1961.
### Table 19.—United States balance of international payments, 1960-67

[Millions of dollars, seasonally adjusted]

<table>
<thead>
<tr>
<th>Type of transaction</th>
<th>1960, fourth quarter</th>
<th>1961</th>
<th>1961</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>First quarter</td>
<td>Second quarter</td>
<td>Third quarter</td>
</tr>
<tr>
<td>Current account and transfers, excluding major Government transactions</td>
<td>1,312</td>
<td>1,389</td>
<td>1,211</td>
</tr>
<tr>
<td>Merchandise trade balance</td>
<td>999</td>
<td>1,080</td>
<td>911</td>
</tr>
<tr>
<td>Net balance on services</td>
<td>545</td>
<td>519</td>
<td>221</td>
</tr>
<tr>
<td>Pensions and remittances</td>
<td>-230</td>
<td>-210</td>
<td>-221</td>
</tr>
<tr>
<td>Major Government transactions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Military expenditures, net</td>
<td>-861</td>
<td>-870</td>
<td>773</td>
</tr>
<tr>
<td>Exports of goods financed by Government grants and loans</td>
<td>-1,013</td>
<td>-1,000</td>
<td>-822</td>
</tr>
<tr>
<td>Exports of services financed by Government grants and loans</td>
<td>583</td>
<td>580</td>
<td>422</td>
</tr>
<tr>
<td>Repayments of Government loans</td>
<td>86</td>
<td>107</td>
<td>87</td>
</tr>
<tr>
<td>Private long-term capital, net</td>
<td>-991</td>
<td>-356</td>
<td>-459</td>
</tr>
<tr>
<td>Balance on &quot;basic&quot; accounts (entries above)</td>
<td>-540</td>
<td>163</td>
<td>230</td>
</tr>
<tr>
<td>U.S. short-term capital and foreign commercial credit</td>
<td>-567</td>
<td>-484</td>
<td>-31</td>
</tr>
<tr>
<td>Errors and omissions</td>
<td>-227</td>
<td>-25</td>
<td>-409</td>
</tr>
<tr>
<td><strong>Over-all balance (deficit (-))</strong></td>
<td>-1,434</td>
<td>-346</td>
<td>-401</td>
</tr>
</tbody>
</table>

1 Preliminary.

2 Excludes exports of goods financed by Government grants and loans.

3 Excludes military expenditures, net, and exports of services financed by Government grants and loans.

4 Includes private expenditures of foreign exchange by United States forces and their dependents; net of foreign military purchases in the United States.

5 Excludes $649 million in receipts from foreign governments through extraordinary debt repayments.

Note.—Minus signs indicate payments to foreigners.

Source: Based on Department of Commerce data.

The payments position in the second and third quarters of 1961 reflects to only a small extent the impact of government balance of payments policies initiated during the year. The full effects of these measures, and of further measures planned or proposed, will take time. So will the full response of U.S. industry to the increased competitive challenge from abroad and to the improvement in the U.S. competitive position achieved in the past two years. But the gap to be narrowed and eventually closed is not large, less than 10 percent of our exports of goods and services and less than one-half of 1 percent of our GNP. Though it will take time to make the needed adjustments and for their effects to outweigh unfavorable cyclical factors, U.S. international reserves provide ample means to cover interim deficits on the basic accounts.

Improvement in the U.S. balance of payments is more than a U.S. problem. Our deficit is matched by corresponding surpluses elsewhere, especially in Europe. Unless the surplus countries allow their surpluses to decline, we cannot reduce our deficit without accentuating the payments problems of other deficit countries. Surplus and deficit countries bear joint responsibility for rectifying payments imbalances and for maintaining the
stability of the international monetary system during the period of adjustment.

Reducing the basic deficit involves either diminishing the outflows on government and net capital account or increasing the current account surplus. Both these approaches are being taken. Measures to reduce the payments deficit must be consistent with the primary objectives of U.S. policy: to fulfill foreign economic and military obligations, to encourage the flow of goods, services, and capital among nations, and to expand the U.S. economy. There is no single dramatic cure-all for the payments problem. Accordingly, the Administration is pursuing a variety of measures on many fronts.

**Military outlays.** U.S. military outlays in foreign countries have averaged nearly $3 billion annually during the last six years even after foreign purchases of military equipment in the United States are deducted. These overseas expenditures by and for U.S. forces—for construction, logistical support, services, and personal purchases—are an integral part of the national defense effort. In addition, the United States provides substantial military grants in kind, valued at $1.8 billion in 1960, to the governments of friendly nations.

The Department of Defense has taken several measures to conserve foreign exchange, including increased procurement of its supplies from U.S. sources even at higher cost to the federal budget.

More than half of the military outlays are in Europe. The Berlin situation is causing an increase in these outlays. The United States is currently discussing with the Federal Republic of Germany and other NATO Allies measures which would have the effect of offsetting these dollar outlays for defense purposes. The Federal Republic of Germany is already making a substantial contribution in this regard. It is the objective of the Administration to work out arrangements which would offset as much of our overseas military expenditures as is feasible.

**Government loans and grants.** Government loans and grants have shifted markedly since the early 1950's from European countries and Japan to the less developed countries, and have risen from $2.5 billion annually in the mid-1950's to an annual rate of $3.8 billion during the first three quarters of 1961. Repayments on past government loans rose steadily during the 1950's, and in 1960 they exceeded $600 million.

The growing size of our aid expenditures reflects the pressing needs of the less developed countries for capital. The recent U.S. payments deficits, however, have necessitated policies to reduce the foreign exchange cost of these programs. The President has instructed the aid agencies to tie development aid directly to purchases of U.S. goods and services wherever possible. In the first nine months of 1961, before this policy had taken full effect, nearly 70 percent of government loans and grant disbursements resulted directly in the export of U.S. goods and services.

Though a policy of tied aid may be unavoidable under present conditions, it has the twofold disadvantage of reducing the efficiency of a given level of aid and of shielding some U.S. export industries from foreign com-
petition. When the United States achieves over-all balance in its international accounts, it will be appropriate to discuss with European countries, Japan, and Canada the possibility of putting all the development aid of industrial countries on an untied basis.

The United States has encouraged other industrial countries to increase their aid efforts and to provide aid on an untied basis when their payments positions permit. Recent arrangements among several industrial countries to provide assistance for the development programs of India and Pakistan are examples of a new cooperative approach. Increased flows of development capital are of vital importance not only to the developing countries but also to the industrial countries, which will be able to sell to a vastly expanded market as the incomes and foreign exchange earnings of the less developed countries rise.

Private long-term investment. A highly developed economy like that of the United States today is quite naturally a source of capital for investment beyond, as well as within, its borders. This country is the world's largest source of savings. Since the United States is far ahead of many countries both in applied technology and in productive facilities per worker, there are bound to be attractive opportunities abroad for duplicating our advanced techniques of production.

Private long-term investment averaged $2.6 billion a year in the last five years, substantially higher than in the early 1950's. In addition, re-invested earnings of U.S. subsidiaries abroad averaged $1.1 billion annually. In 1961, U.S. private long-term investment abroad is estimated to have been about $2.3 billion.

While outflows of U.S. capital are adding to our national wealth foreign properties which may yield substantial return flows of earnings in the balance of payments over future years, these outflows increase the payments deficit in the short run.

Since 1958-59, the share of U.S. direct investment outflows going toward Europe has increased substantially. The promise of an expanding European Common Market has enhanced the attractiveness of Europe as a location for production. Flows of saving to develop productive opportunities abroad increase the efficiency of the world economy. However, capital is not allocated efficiently when it moves primarily in response to tax advantages or to restrictive or discriminatory trade barriers abroad. If the President's trade program is enacted and the new common external tariff in Europe is reduced through negotiations, artificial incentives to invest behind the European tariff wall will be reduced. This is one important way in which an expansionist trade policy will improve the U.S. payments position.

The Administration has also proposed changes in the tax treatment of foreign income which, in addition to achieving greater equity relative to tax treatment of domestic income, will ease our balance of payments deficit. Under the President's proposal, earnings on U.S. investments in other
industrial countries would be taxed on the same basis as corporate earnings in the United States. This would be achieved by taxing U.S. corporations each year on their current share of the undistributed profits realized in that year by subsidiary corporations organized in economically advanced countries. Any decline in the outflow of U.S. capital resulting from a withdrawal of existing tax inducements would be consistent both with efficiency in the allocation of capital resources in the world and with equity between U.S. firms operating abroad and competing firms located in the United States. Legislation has also been proposed which would curtail tax haven privileges.

An additional proposal, discussed in earlier chapters, would provide a tax credit to spur domestic investment.

These measures, along with rising domestic activity, would increase the relative attractiveness of domestic, as opposed to foreign, investment. A higher rate of domestic economic expansion would increase the attractiveness of the United States for investment by foreigners.

The United States is urging countries in Western Europe to liberalize restrictions on the outflow of capital owned by their residents in order to permit more foreign capital issues to be offered in their markets and to permit more investment in the United States and in underdeveloped countries. Many European countries still limit foreign issues in their capital markets and control tightly purchases of foreign securities by their residents.

Services. Net exports of services, excluding military expenditures and sales, were at an annual rate of $2.3 billion during the first three quarters of 1961. These services include travel expenditures, transportation services, royalties, interest, and dividends. Repatriated earnings on U.S. investments abroad, which are counted as receipts for services in the balance of payments accounts, amounted to $3.2 billion in 1960. Our expenditures on foreign travel were $1.7 billion, and foreigners spent nearly $1.0 billion in this country.

During 1961, an Office of Tourism was established in the Department of Commerce to encourage foreign travel to the United States. In addition, the duty-free tourist allowance for returning U.S. travelers was reduced from $500 to $100 a person.

The proposed change in tax provisions regarding overseas investment should result in an increase in the repatriation of earnings from U.S. investments abroad.

Merchandise trade. Merchandise trade has earned large net receipts in every year since the war. The trade surplus has on average increased, but it has not increased sufficiently to cover the combined rise in overseas military, foreign aid, and investment outlays.

Restrictive commercial policies would be one way to try to check imports and increase the trade surplus. But raising tariffs and imposing quotas, while perhaps improving the trade position temporarily, would be
inconsistent with the liberal trade objectives of the United States and would invite retaliatory action abroad, thus reversing any temporary gains.

Imports could also be checked by restraining domestic economic activity. But this would be an absurdly costly policy for the United States because imports comprise only a small part of each dollar of final demand. To obtain a $1 billion reduction in imports might require a $25–35 billion reduction of GNP. Even this decrease in imports would not result in an equivalent improvement in the trade balance, for, as the dollar earnings of other countries declined, some of our best customers would curtail their purchases in the United States. Moreover, the prospects for fundamental balance of payments improvement would be dim in a continuously slack economy beset by excess capacity and deficient in incentives to make investments at home which raise productivity and lower costs. Sacrificing recovery for a temporary gain in the balance of payments position would be shortsighted and would not inspire confidence in the dollar.

Clearly, our efforts to improve the trade position must be expansive rather than restrictive. A program has been established under the direction of the Department of Commerce to promote exports, both by increasing awareness among U.S. businessmen of sales opportunities abroad and by increasing foreign awareness of the wide array and high quality of U.S. products. The program includes regional conferences and a more active field service in the United States to provide information on foreign markets, trade exhibits and missions abroad, and an increased number of government commercial representatives to aid the U.S. businessman abroad.

In addition to improving the flow of information about export possibilities, steps have been taken to improve U.S. competitiveness in the important dimensions of credit availability and export insurance for commercial and political risks—steps designed to place the U.S. businessman on a par with foreign exporters. The Export-Import Bank has established, in cooperation with the commercial banks and a group of insurance companies, simplified and expanded opportunities for obtaining credit and export insurance. An exporter is now able to arrange for full credit and insurance advantages directly with his local bank.

A fundamental requirement for increasing our trade balance is a domestic environment of full recovery and growth without inflation. We must exploit the gains in productivity available from bringing into full use the excess capacity now prevalent in U.S. industry, and we must speed the advance of U.S. technology. The measures to accelerate the growth of productivity outlined in Chapter 2 are, for these reasons, essential elements of policy for long-run improvement in the balance of payments. In particular, the tax credit for investment proposed by the President and the revision of depreciation guidelines underway at the Treasury will promote investment at home and make American industry more competitive. It is true that economic growth, by raising incomes in the United States, will tend to increase the purchases of foreign goods by U.S. consumers and
businesses. But economic growth achieved through advances in productivity and improvements in technology will also enable U.S. goods to compete more effectively with foreign products both in the United States and in foreign markets. The technological leadership and high productivity of the United States have proved in the past to be vital sources of our comparative advantage in world markets. And today, the most rapidly growing countries in the free world generally rank among those with the strongest international payments positions.

An accelerated advance in productivity will be of little help to the balance of payments, however, if the improvements are eroded away by increases in money costs and prices. The price increases of 1955–57 impaired the competitive position of several important U.S. industries in world markets. More recently, price and wage developments in the United States have been favorable relative to those in other countries. The stability of U.S. prices in the last three years, and the reasons for optimism concerning U.S. prices in the current economic recovery, are discussed in Chapter 4. Policies to avoid cost inflation at home can be reinforced by a liberal trade policy which expands the area of international competition to which U.S. producers are exposed.

The future course of exports will depend not only on U.S. policies but also on business activity, prices and wages, and commercial policy abroad. Successful international trade negotiations under the proposed Trade Expansion Act will provide increasing opportunities for U.S. exports. In addition, the United States continues to press for the elimination of open and concealed discrimination against U.S. goods—agricultural products provide outstanding examples—and against the products of third countries, many of which are good customers of the United States.

The continued expansion of the European economies is of great importance for the future of U.S. exports. And the rapid growth of all the industrial countries is of vital concern to the primary producing countries whose exports have been largely stagnant in recent years. As the exports of the primary producing countries increase, their purchases from the United States and other industrial countries will expand.

Short-Term Capital Account

Dollars are transferred to foreigners not only through deficits in the basic accounts of the United States, but also through short-term lending by Americans to foreigners. Much of this lending is commercially oriented and often provides financing for American exports. During the first half of 1961, for example, a large part of the short-term capital outflow from the United States was used to finance an increase in exports from the United States and other countries to Japan. An increase in such commercial credit will be a natural consequence of policies taken during 1961 to boost U.S. exports.
However, some flows of short-term capital are not linked directly to export financing. These flows of funds, both U.S. and foreign owned, have increased markedly since the establishment of external currency convertibility of the leading European countries in 1958, the relaxation of restrictions on capital transactions by their own nationals, and the re-establishment of confidence in the stability of European currencies.

Short-term capital movements are sensitive to differences in interest rates between major financial centers. In late 1960, for example, when yields on short-term securities were substantially higher in Canadian and European markets than in the United States, a significant volume of U.S. funds moved abroad. Again in the last few months of 1961 substantial amounts of capital moved abroad to benefit from higher yields.

Liquid funds also move in hope or fear of changes in exchange rates or regulations. For example, the revaluations of the German mark and the Dutch guilder in March 1961 led to expectations of further revaluations and resulted in large short-term capital flows. Movements of this kind often reflect objective factors related to basic balance of payments positions. But they sometimes respond to rumor and opinion unrelated to the basic situation.

A notable feature of the U.S. balance of payments in the past two years was the sharp swing in the balancing item, "errors and omissions," from a net inflow through 1959 of some $500 million a year to a net outflow of $650 million in 1960 and a further $400 million in the first half of 1961. Preliminary estimates for late 1961 also show a large unrecorded outflow. This change no doubt reflected a sizable transfer of U.S. capital abroad and a withdrawal of foreign private capital, both of which moved outside channels normally covered by our recording network.

Flows of short-term capital, although they frequently perform a useful function, can be seriously disruptive. They can be large, sudden, erratic, contagious, and self-reinforcing. Monetary authorities are gradually adjusting their policies and techniques to cope with these flows. During the past two years, several steps were taken to reduce the incentive to shift capital among financial centers. Foremost among these was increasing cooperation among central banks to avoid large differentials in short-term interest rates among countries. High interest rates in Europe were lowered in late 1960 and early 1961. U.S. monetary policy and technique have been adapted to the new international financial environment in the manner described in Chapter 1. Although the Federal Reserve has maintained generally easy money and credit conditions, U.S. short-term rates have been held above levels characteristic of previous recession and recovery periods.

In December 1961, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation raised permissible interest rates on commercial-bank time deposits. The ceiling rate for deposits exceeding 12 months was raised from 3 percent to 4 percent a
year. As banks move rates up to the new ceilings, they will increase the attractiveness of holding funds in the United States.

Finally, the U.S. Treasury has, for the first time since the mid-1930’s, engaged in foreign exchange operations in cooperation with foreign central banks. The Treasury this year undertook transactions in German marks and Swiss francs, both on a current basis and in the forward exchange market. The aim was to increase the cost to traders and investors of exchange risk “cover” for movements out of dollars, diminishing the incentive to shift funds abroad and increasing the incentive to move funds here.

Although these policies will moderate the disruptive flows of short-term capital, they cannot eliminate them. Further measures are therefore needed to neutralize or minimize the possible effects of such flows on the international monetary system.

**Measures To Strengthen the World Monetary System**

Stability of the present world monetary system depends upon confidence in the value of the dollar. Therefore, a primary aim of the United States and of other countries must be to correct the underlying conditions which result in persistent U.S. deficits and persistent surpluses elsewhere. This is fundamental, but it will take time.

While policies to achieve this fundamental adjustment are taking effect, full confidence must be maintained in the ability of the United States to meet foreign demands for gold. There are a number of measures which can strengthen the “banking” or liquidity position of the United States while the fundamental adjustment of the payments position proceeds. Some of them apply to the dollar alone; others are general measures to strengthen the world monetary system. All of them require a high degree of international consultation and cooperation.

One means of strengthening the U.S. liquidity position, as well as its payments position at a given time, is to obtain advance repayment of long-term debts owed to the U.S. Government. For example, in April the Federal Republic of Germany prepaid $587 million to the United States. This translated a long-term U.S. asset partly into a reduction of short-term U.S. liabilities and partly into a rise in U.S. holdings of German marks. The United States still has outstanding about $2 billion of long-term loans to countries that have strong payments positions.

The gross reserve position can also be strengthened by borrowing directly in foreign currencies from other governments or central banks. This device was employed recently on a small scale when the United States borrowed from Switzerland $46 million in Swiss francs in order to support forward exchange operations of the Treasury.

Recently, there has been increasing recognition that, even when large movements of private short-term capital cannot be prevented, they can be
offset by reverse movements of official capital. In March 1961, several central banks agreed through the so-called Basle arrangements to extend short-term credit to the United Kingdom to offset the flight of private funds from London.

Several countries now consider their drawing rights on the International Monetary Fund as an integral part of their foreign exchange reserves. In his Balance of Payments Message of February 6, 1961, President Kennedy stated that “access to the Fund’s resources must be regarded as a part of our international reserves” and that, if appropriate, the United States would use its drawing rights. The drawing from the Fund of currencies equivalent to $1.5 billion by the United Kingdom in August, and the prompt repayment of $420 million as British reserves rose, indicate the flexibility with which drawing rights on the Fund can be used to supplement reserves. Furthermore, in accordance with recent IMF policy, member countries have increasingly made drawings in currencies other than the dollar, which the Fund formerly relied on heavily for most of its operations. This policy puts to effective use the Fund’s holdings of the currencies of surplus countries. But the Fund’s holdings of some of these currencies may not be fully adequate to meet the potential demands for them.

Improvement of the Fund’s access to the currencies of the major industrial countries was discussed at the annual Fund meeting in Vienna in September. It was announced in early January that ten industrial countries have agreed to lend amounts of their currencies totaling $6 billion, to the Fund if these resources should be required to forestall or cope with an impairment of the international monetary system. Availability of these special resources should enable the Fund better to perform its function of financing temporary payments deficits in the interests of maintaining general exchange rate stability.

In his February Message the President said, “Increasing international monetary reserves will be required to support the ever-growing volume of trade, services and capital movements among the countries of the free world. Until now the free nations have relied upon increased gold production and continued growth in holdings of dollars and pounds sterling. In the future, it may not always be desirable or appropriate to rely entirely on these sources. We must now, in cooperation with other lending countries, begin to consider ways in which international monetary institutions—especially the International Monetary Fund—can be strengthened and more effectively utilized, both in furnishing needed increases in reserves, and in providing the flexibility required to support a healthy and growing world economy.”

The agreement to supplement the resources of the Fund is an important step toward strengthening the international monetary system to meet the demands which the continuing economic progress of the free world will place upon it in the future.
Finally, the newly created Organization for Economic Cooperation and Development, comprising 18 European countries, the United States, and Canada, provides a continuing forum in which payments imbalances and internal or international monetary problems of concern to all members—as well as trade, development aid and other matters of common interest—can be discussed frankly and constructively. Still another forum for international cooperation is provided by the monthly meetings of central bankers at the Bank for International Settlements in Basle. Although the United States is not a member of the Bank for International Settlements, representatives of the Federal Reserve System participate informally in the discussions.

These measures of cooperation among nations, together with the large gold reserves of the United States, give this country the time to carry through the necessary adjustment in its balance of payments—and to carry it through in ways consistent with general economic expansion at home and abroad, with promotion of a world economy in which goods, services, and capital flow freely, and with the responsibilities of world leadership. They give us time, but not time to waste.
Chapter 4

Price Behavior in a Free and Growing Economy

The Objectives

PRICE BEHAVIOR embraces both changes in the over-all level of prices throughout the economy and changes in price structure—the relation of particular prices to each other. Changes in either the level or the structure of prices have far-reaching influences which can affect for better or worse the performance of a free economy. Both aspects of price behavior are closely related to major problems which confront the U.S. economy today.

Our success in solving the international payments problem (discussed in the previous chapter) will depend to a major extent on our ability to avoid inflation. To recognize this compelling reason for price stability is not to say that stable prices are desirable only for their contribution to the achievement of equilibrium in our balance of payments. Even creeping inflation has effects on the distribution of income which are always capricious and often cruel, and it may generate perverse changes in the structure of prices. Galloping inflation is profoundly disruptive of economic efficiency and growth. But to these persisting arguments for avoiding inflation is now added the pressing and immediate need to strengthen the competitiveness of U.S. industry in world markets.

International competitiveness is affected by many considerations, including quality, variety, service, credit facilities, and promptness in delivery. But after full weight is given to these considerations, price remains at the heart of the matter. The effect of price developments on our international competitive position will not, of course, be determined by the behavior of U.S. prices alone; what counts is the change in the ratio of U.S. prices to the prices of those countries with which we compete in world markets. There is independent reason to expect in the next few years a moderate upward price trend in some competitive countries, but a decline in the ratio of our prices to theirs is obviously more likely if our own prices remain stable than if they rise.

Large potential gains in national economic welfare are at stake in the course of price developments over the next year or two. Stable prices—together with the many other measures to strengthen our payments position discussed in Chapter 3—will move us toward equilibrium in our inter-

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national payments. This, in turn, will remove a possible impediment to the vigorous pursuit of full employment.

It is always possible to strengthen the balance of payments, at least for a time, by weakening the economy. Checking and reversing the economic expansion would reduce our demand for imports by reducing our demand for all goods and services. Raising interest rates sharply would probably attract some foreign capital to the United States, but it would raise the cost and reduce the volume of domestic expenditures for new business plant and equipment and residential construction. This road to balance of payments equilibrium endangers the interests of the whole Nation and specifically the interests both of labor and of business; for the former it increases unemployment, while for the latter it lowers profits. Both groups stand to gain from price level stability, which lays the foundation for the harmonious coexistence of balance of payments equilibrium with full employment and rapid economic growth.

Price level stability does not, of course, require stability of all prices. On the contrary, the structure of relative prices constitutes the central nervous system of a decentralized economy. Changing relative prices are the signals and stimuli which foster the efficiency and guide the growth of such an economy.

Changing relative prices serve to ration scarce goods and services. They encourage consumers and business firms to economize on the use of things which have grown scarcer, and to use more freely those things which have become more abundant. They attract resources into the production of those things for which demand has increased, and encourage the outflow of resources from the production of things for which demand has declined. They provide generous rewards to innovators, and then assure that the benefits arising from innovation are widely diffused throughout the economy. They direct economic activity into the most productive channels. A smoothly functioning price system, while it cannot solve all of the resource-use problems of our economy, is nevertheless an indispensable agent for reconciling decentralized private decision-making with national economic objectives.

In the context of current economic policy goals, flexible relative prices play an important role in encouraging maximum production and shaping the pattern of growth. As the economy approaches full utilization of productive resources, premature and stubborn bottlenecks may arise in some sectors while labor and capital are underutilized elsewhere. This danger is lessened if productive resources are sufficiently mobile to shift promptly into the sectors of the economy which are coming under pressure. Flexible price and wage relationships are not in themselves sufficient to assure that capital and labor will flow from relatively declining to relatively expanding sectors. But flexible price and wage relationships can smooth the process, both by signaling the directions in which resource movements should occur, and by providing incentives to encourage such
shifts. Prices must fall as well as rise, however, if changing relative prices are to play their role in guiding resource movements without forcing a steady rise in the over-all level of prices.

**The Present Situation**

**Price Developments in Perspective**

The frequent characterization of the postwar period as generally “inflationary” obscures two important facts. First, increases in wholesale prices were concentrated in three periods: 1946–48, 1950, and 1955–57. In the other 9 of the 16 postwar years taken together, the net movement of wholesale prices was downward. Second, since the middle of 1958, the wholesale price level in the United States has been stable, and there are signs that the inflationary impulses set off by the second World War and reinforced by the Korean conflict have been weakening.

**War-induced inflation.** By far the strongest burst of inflation occurred immediately after the end of the war, and for obvious reasons. The stock of consumers’ and producers’ durable goods had been depleted during the long years of depression and war. Private debt had been reduced, and the heavy reliance on public debt financing of the war had provided households and firms with large supplies of liquid assets.

The result was a demand for consumer goods and plant and equipment which far exceeded the capacity of the economy to produce them. Although the Federal Government ran a substantial cash surplus in the 1946–48 period, which had the effect of reducing total demand for goods and services, aggregate demand nevertheless outran supply until late in 1948. From the end of the war through September 1948, the consumer price index rose by 35.2 percent, and the wholesale price index by 54.4 percent. In the recession which followed, both consumer and wholesale prices fell, the former by 1.9 percent between November 1948 and October 1949, the latter by 6.5 percent.

A new burst of excess-demand inflation was set off by the Korean hostilities. Between June 1950 and February 1951, consumer prices rose by 8.0 percent and wholesale prices by 16.3 percent, as consumers and businesses, remembering the shortages of 1942–45, scrambled to build up stocks of goods.

These two inflationary episodes account for 70 percent of the increase in the level of consumer prices since the second World War, and more than account for the increase in the wholesale price level. Costs rose steeply in these periods, but the major force pulling prices upward was clearly pressure of excessive demand for a wide range of products.

**Post-Korean price stability.** The scare-buying of late 1950 and early 1951 drove prices to a level from which a mild reaction set in. From mid-1951 to mid-1955, except for construction costs and the index of services to consumers, most price indexes remained stable or fell. Consumer prices for
food and other commodities, as well as wholesale price indexes of farm and nonfarm commodities, were lower in mid-1955 than they had been in mid-1951, despite the fact that large parts of the economy had operated at near capacity levels from the fall of 1952 to the fall of 1953.

Construction costs failed to stabilize in the post-Korean period; while the average of wholesale prices fell by 5.7 percent between February 1951 and May 1955, the Department of Commerce index of construction costs rose by 8.8 percent.

Another exception to this record of stability—consumer services—is highly important. Services have a weight of about one-third in the consumer price index. Prices of services, taken as a group, have risen in every year since the war, and have accounted for much of the rise in the consumer price index.

Because of the heterogeneous character of the services category, no single explanation can account for the behavior of the services index. Some tentative observations may be made, however, about the forces influencing the prices of particular services. Residential occupancy costs, with a weight of about 42 percent within the services category, include rents, mortgage payments and interest, real estate taxes, and property insurance. Rents and home prices tend to be influenced in the short run by the vacancy rate, and in the long run by changes in construction costs, interest rates, and property taxes. Movements in all these components tended to push the index upward in the postwar period. In addition, the retention of rent controls in some important areas well into the postwar period tended to delay the adjustment of rents to market forces. Medical care service prices, with a weight of about 14 percent, have been rising steeply. This is a sector, however, in which there has probably been a substantial improvement in the quality of services. If it were possible to take account of quality changes in the index, the rate of increase would have been less. Regulated utility services (telephone, gas, electricity, and water), with a combined weight of about 10 percent, are subject to substantial price lags. Depreciation costs recognized for rate-making purposes have tended to rise as the share of low-priced prewar capital goods in the rate base has diminished and the share of higher-priced postwar goods has increased. Public transportation services (transit fares and railroad fares), with a combined weight of about 4 percent, may have been influenced to a limited extent by the same forces mentioned in connection with regulated utility services, and to a further extent by the effects of declining demand on unit cost in industries where overhead costs are high. Personal care services (men’s haircuts and certain beauty parlor services), with a weight of about 3 percent, are services not readily susceptible to improvements in labor productivity, though wages in this sector tend to move up in step with economy-wide trends.

Inflation, 1955–58. The relative price stability which began in 1951 gave way in 1955 to renewed inflationary pressure which persisted into early
1958. Although prices rose far less sharply than in 1946-48 or 1950-51, consumer prices rose by 8.0 percent from May 1955 to March 1958, and wholesale prices increased by 8.9 percent.

In contrast to the two earlier inflationary bursts, there is still considerable uncertainty as to the causes of rising prices during this period. A simple explanation running in terms of over-all excess demand is not satisfactory. If aggregate excess demand prevailed at all, it existed only briefly toward the end of 1955. After the end of 1955, capacity utilization slackened as investment created capacity more rapidly than final demands were increasing. Employment of production workers in manufacturing began to decline in the latter half of 1956 and was lower in 1957 than in 1955. The average work-week in manufacturing declined over this period—from 40.7 hours in 1955 to 40.4 in 1956 to 39.8 in 1957. Unemployment as a percent of the civilian labor force, seasonally adjusted, dipped below 4.0 percent in only three months during the entire period.

Any explanation of the 1955-58 price experience must give special weight to the fact that the 1955-57 boom was concentrated in durable manufactured goods. Demand strained production capacity in the machinery and equipment industries. Except for the third quarter of 1956, in which a strike occurred, the iron and steel industry operated at a rate above 90 percent of capacity from the second quarter of 1955 through the first quarter of 1957. Automobile production set an all-time record in 1955.

In this sector of the economy, prices and wages rose sharply. More than three-fourths of the 1955-58 rise in the index of wholesale industrial prices was directly attributable to price increases in metals and metal products and machinery and motive products (including motor vehicles). Substantial employment cost increases were negotiated in the automobile settlement of 1955 and the steel settlement of 1956. Both were three-year agreements, with the result that large wage commitments made in a boom environment became effective as the economy was slowing down. Price and wage behavior in this sector initiated impulses which spread to other parts of the economy, both via increases in materials and equipment cost and via imitative influences in wage settlements.

Elements of major importance in the 1955-58 episode were thus the existence of relatively high demand, principally in one sector of the economy; the use of market power by management to maintain profit margins despite rising costs; the exercise of market power by labor unions in an effort to capture a substantial share of rising profits for their membership; and the transmission of these developments to other sectors of the economy.

One of the striking and significant aspects of the 1955-58 inflation was the leading part played by industries which are important exporters. Metals, machinery, and transport equipment make up about two-thirds of U.S. exports of manufactures. What in this context is more important, these U.S. prices rose faster than the prices for similar goods in foreign countries. To take but one example, between 1956 and 1958 U.S. steel
prices rose nearly 20 percent more than the average price rise in five other major steel exporting countries.

During this period the United States experienced a noteworthy decline in its share of world exports of manufactures—from 30 percent in 1956 to 27 1/2 percent in 1958. The decline was even sharper for some product groups; the U.S. share of world exports of iron and steel products, for example, declined from 19 percent to 14 percent. The relative increase in U.S. prices probably contributed—along with the rapid postwar growth in capacity and output abroad—to the drop in American export shares.

Price behavior since 1958. Since mid-1958, there has been stability on the average in the prices of commodities at wholesale and retail, with a continuing upward trend in consumer service prices. This record of relative price stability is in part the result of widespread excess capacity in the last few years, but it may also reflect a weakening of lagged price responses to the sharply inflationary episodes of 1946-48 and 1950-51.

An important element in the cessation of inflationary pressure has been the stability shown in the prices of metals and machinery. The index of metal and metal products, which rose by 17 percent from the beginning of 1955 to the end of 1956, and drifted irregularly upward through late 1959, has since remained below its 1959 high. The index of machinery and motive products, which rose by 22 percent from January 1955 to September 1959, has also been stable since then. Steel prices were raised once a year in the period 1952-58, for a total increase of 50 percent, but have not been raised since 1958.

Movements in construction costs are in sharp contrast to this pattern of price stability. After increasing against the general price trend over 1951-55, they rose 10.5 percent from May 1955 through March 1958—an increase significantly greater than the 8.9 percent rise in the wholesale price level over the same period. From March 1958 through December 1961, the increase was 5.8 percent.

As Chart 13 shows, a period of stability in the wholesale price index tends to be a period of slow rise in the consumer price index and in the implicit price index for GNP. The reason for the divergent behavior of consumer prices is primarily the service component already discussed; the price index for GNP rises because of the methods of measurement used for the government sector (in which no allowance is made for productivity increase), and for plant and equipment spending (where only partial allowance is made for quality change).

The chart also calls attention to an important difference between price behavior in the 1961 recovery and in the recovery of 1958. In 1958, stability in the wholesale price index resulted from a significant reduction in the prices of farm products and processed foods, balanced by a rise in industrial prices. In the first 10 months of recovery in 1958-59, the index for industrial commodities rose by 1.8 percent. By contrast, in 1961, the index of industrial prices fell by 0.3 percent between February and
CHART 13

Price Developments

INDEX, 1961 = 100 (Ratio scale)

GROSS NATIONAL PRODUCT
IMPLIED PRICE DEFLATOR

INDEX, 1947-49 = 100 (Ratio scale)

WHOLESALE PRICES

INDUSTRIALS

ALL COMMODITIES

FARM PRODUCTS AND PROCESSED FOODS

INDEX, 1947-49 = 100 (Ratio scale)

CONSUMER PRICES

SERVICES

ALL ITEMS

COMMODITIES

NOTE: TOP PANEL, QUARTERLY DATA; OTHER PANELS, MONTHLY DATA.

SOURCES: DEPARTMENT OF COMMERCE, DEPARTMENT OF LABOR, AND COUNCIL OF ECONOMIC ADVISERS.
December, reinforcing rather than offsetting a fall of 1.9 percent in farm and food prices. In all of the previous postwar recoveries, by contrast, the index of wholesale industrial prices rose over the first 10 months of recovery.

From the recession's turning point in February, through November, consumer prices rose by 0.6 percent. While this was a greater increase than the 0.2 percent by which the index rose in the first 9 months of recovery from the 1958 trough, the difference in performance is attributable to movements in the retail food index, which fell more sharply after the 1958 upturn than in 1961. The behavior of other major components was similar in the two recoveries, except for rents, which rose slightly more in 1958 than they did in 1961.

More than three-fourths of the rise in consumer prices during 1961 was attributable to higher service prices, particularly advances for health insurance and other health services, movie admissions, rent, and public transportation. Moderating the rise in the service price index were lower average mortgage interest rates and stable average prices for utilities.

Wage and Cost Developments in Perspective

Wages and salaries are at the same time the principal cost to employers, the main source of income to employees, and the major source of demand to the economy as a whole.

If living standards are to rise over time, real wages must increase. Stability in the general price level means, therefore, that average money wage rates should follow a generally rising path. As output per man-hour increases, rising money wage rates can be absorbed into stable labor costs per unit of output. So long as unit labor costs do not increase, rising wages are fully compatible with stability in the price level.

Whatever its cause, a rising price level is characteristically accompanied by a rate of wage increase in excess of the rate of increase in output per man-hour. It is quite true, of course, that when employment costs per man-hour rise more rapidly than output per man-hour, prices sooner or later will increase. But it is equally true that, when prices are pulled up by excess demand, competition for labor will tend to raise employment costs per man-hour faster than output per man-hour increases. Thus wage increases will tend to outstrip productivity increases both when the inflationary pressures arise from cost and when they arise from demand. The mere coexistence of rising prices and wages rising faster than productivity tells nothing about causation.

Postwar wage changes. While wages rose throughout the postwar period, they rose more rapidly in the first part of the period than in more recent years. The primary cause of the most rapid increases lies in the excess demand which was the legacy of the second World War and which arose again during the Korean mobilization. Hourly compensation in manufacturing increased at an average rate of nearly 7 percent a year between 1947
and 1953; the rate of increase fell to 5 percent between 1953 and 1957, and to less than 4 percent between 1957 and 1961 (Table 20). The period 1947–53, of course, included most of the two war-induced inflationary booms.

Table 20.—Changes in compensation and productivity in all private nonagricultural industries and in manufacturing industries, 1947 to 1961

<table>
<thead>
<tr>
<th>Item</th>
<th>Percentage change per year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1947 to 1961 1</td>
</tr>
<tr>
<td>Private nonagricultural industries, all employees:</td>
<td></td>
</tr>
<tr>
<td>Average hourly compensation 1</td>
<td>5.1</td>
</tr>
<tr>
<td>Output per man-hour</td>
<td>2.5</td>
</tr>
<tr>
<td>Manufacturing Industries, all employees:</td>
<td></td>
</tr>
<tr>
<td>Average hourly compensation 1</td>
<td>5.5</td>
</tr>
<tr>
<td>Output per man-hour</td>
<td>2.9</td>
</tr>
<tr>
<td>Manufacturing Industries, production workers:</td>
<td></td>
</tr>
<tr>
<td>Average gross hourly earnings</td>
<td>4.7</td>
</tr>
<tr>
<td>Average hourly earnings adjusted to exclude overtime and inter-industry shifts</td>
<td>4.7</td>
</tr>
</tbody>
</table>

1 Preliminary.
2 Wages and salaries of all employees and supplements to wages and salaries such as employer contributions for social insurance, for private pension, health, and welfare funds, for injuries, for pay of the military reserve, etc.

Sources: Department of Commerce and Department of Labor.

In the post-Korean years—a period which included three of the four postwar recessions—over-all demand conditions played a less decisive role in wage behavior. The movement of wages during this period reflected in part the power exercised in labor markets by strong unions and the power possessed by large companies to pass on higher wage costs in higher prices. Although the high demand of the 1955–57 period was concentrated in the area of durable manufactures, wages also rose by substantial increments in some less prosperous but highly organized industries.

The post-Korean years were marked by the coincidence of relatively large wage increases with declines in industry employment. Table 21 illustrates these developments as they are reflected in changes in average hourly earnings and the number of production workers for selected industries. Earnings in textiles and apparel, typically lower than the average for all manufacturing industries, fell further behind during the years 1954–61. Workers in retail trade received percentage wage increases equal to the average of those in manufacturing; the initial low wage level and the increase in employment in retailing suggest that this rise in wages reflects pressure of demand. Construction worker employment increased, and wages rose more than the average for manufacturing; indeed, over the entire postwar period, average hourly earnings in construction have risen more than 100 percent against a rise of 80 percent for production workers in manufacturing. In manufacturing and mining, unionization was undoubt-
### Table 21.—Changes in average hourly earnings and employment of production workers in selected industries, September 1954 to September 1961

<table>
<thead>
<tr>
<th>Industry</th>
<th>Average hourly earnings (dollars)</th>
<th>Employment (thousands)</th>
<th>Percentage change, September 1954 to September 1961</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Septem-</td>
<td>Septem-</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ber 1954</td>
<td>ber 1961</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Manufacturing 1</td>
<td>1.78</td>
<td>2.33</td>
<td>12,821</td>
</tr>
<tr>
<td>Blast furnaces and basic steel products</td>
<td>2.29</td>
<td>3.17</td>
<td>537</td>
</tr>
<tr>
<td>Motor vehicles and equipment</td>
<td>2.24</td>
<td>2.34</td>
<td>479</td>
</tr>
<tr>
<td>Flat glass</td>
<td>2.49</td>
<td>3.16</td>
<td>26</td>
</tr>
<tr>
<td>Fabricated metals</td>
<td>1.89</td>
<td>2.43</td>
<td>825</td>
</tr>
<tr>
<td>Metal cans</td>
<td>1.98</td>
<td>2.91</td>
<td>55</td>
</tr>
<tr>
<td>Petroleum refining</td>
<td>2.42</td>
<td>3.21</td>
<td>142</td>
</tr>
<tr>
<td>Tires and inner tubes</td>
<td>2.25</td>
<td>3.13</td>
<td>84</td>
</tr>
<tr>
<td>Textile-mill products</td>
<td>1.35</td>
<td>1.64</td>
<td>955</td>
</tr>
<tr>
<td>Apparel and related products</td>
<td>1.38</td>
<td>1.63</td>
<td>1,065</td>
</tr>
<tr>
<td>Bituminous coal mining</td>
<td>2.41</td>
<td>3.15</td>
<td>201</td>
</tr>
<tr>
<td>Contract construction</td>
<td>2.40</td>
<td>3.22</td>
<td>2,489</td>
</tr>
<tr>
<td>Class I railroads</td>
<td>1.94</td>
<td>2.60</td>
<td>4,196</td>
</tr>
<tr>
<td>Retail trade 5</td>
<td>1.30</td>
<td>1.70</td>
<td>5,589</td>
</tr>
</tbody>
</table>

1 Includes data for Alaska and Hawaii.
2 Also includes industries not shown separately.
3 Increase of less than 0.5 percent.
4 Data relate to all employees.
5 Excludes eating and drinking places.

Note.—Data relate to production workers or nonsupervisory employees, except as noted.
Source: Department of Labor.

...edly a factor in the increase in wages during a period of declining employment; the above-average increase in wages in construction reflects both unionization and the stimulus of strong demand.

The effect of unionization is also reflected in the contrast between earnings and employment of salaried workers in manufacturing and those of production workers in manufacturing over the period. Although aggregate salaries in manufacturing have risen twice as rapidly as aggregate wages, annual disbursements per worker for salaried workers increased at an average rate of only 3.8 percent a year during the period 1947–61, while disbursements per production worker increased at a rate of 4.9 percent. At the same time, the number of salaried workers was increasing at a rate of 3.7 percent a year, and the number of production workers declining at a rate of 0.5 percent.

**Recent wage developments.** Although wages and fringe benefits have continued to increase throughout the economy, the rate of increase in hourly earnings in manufacturing has declined steadily since 1957. The decline has been not only steady but large; as Table 22 demonstrates, the rate of increase in adjusted hourly earnings has fallen by one-half since 1955–56. These percentage movements are consistent with recent declines in median wage increases, measured in cents per hour, under major collective bargaining contracts. These are shown in Table 23.
Table 22.—Changes in average hourly earnings and hourly compensation in manufacturing industries, 1955 to 1961

<table>
<thead>
<tr>
<th>Period</th>
<th>Percentage increase</th>
<th>Adjusted hourly earnings</th>
<th>Average hourly compensation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Current prices</td>
<td>Constant prices</td>
</tr>
<tr>
<td>1955 to 1956</td>
<td>5.4</td>
<td>3.8</td>
<td>6.2</td>
</tr>
<tr>
<td>1956 to 1957</td>
<td>5.1</td>
<td>1.7</td>
<td>6.0</td>
</tr>
<tr>
<td>1957 to 1958</td>
<td>4.1</td>
<td>1.3</td>
<td>3.9</td>
</tr>
<tr>
<td>1958 to 1959</td>
<td>3.4</td>
<td>2.5</td>
<td>4.1</td>
</tr>
<tr>
<td>1959 to 1960</td>
<td>3.3</td>
<td>1.8</td>
<td>4.1</td>
</tr>
<tr>
<td>1960 to 1961</td>
<td>2.7</td>
<td>1.6</td>
<td>3.4</td>
</tr>
</tbody>
</table>

1 Wages of production workers adjusted to exclude overtime and interindustry shifts.
2 Wages and salaries of all employees and supplements to wages and salaries such as employer contributions for social insurance, for private pension, health, and welfare funds, for injuries, for pay of the military reserve, etc.
3 Preliminary.

Sources: Department of Commerce and Department of Labor.

Table 23.—Median hourly wage increases negotiated or effective in major collective bargaining situations, 1956-61

<table>
<thead>
<tr>
<th>Year</th>
<th>Median hourly wage increases (cents)</th>
<th>Negotiated during year</th>
<th>Negotiated or effective during year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1956</td>
<td></td>
<td>10.7</td>
<td>10.8</td>
</tr>
<tr>
<td>1957 Invent</td>
<td></td>
<td>10.6</td>
<td>12.7</td>
</tr>
<tr>
<td>1958 Invent</td>
<td></td>
<td>8.8</td>
<td>12.6</td>
</tr>
<tr>
<td>1959 Invent</td>
<td></td>
<td>8.8</td>
<td>8.8</td>
</tr>
<tr>
<td>1960 Invent</td>
<td></td>
<td>8.7</td>
<td>9.4</td>
</tr>
<tr>
<td>1961 Invent</td>
<td></td>
<td>7.0</td>
<td>8.0</td>
</tr>
</tbody>
</table>

1 Preliminary.

Note.—Data are limited to major collective bargaining situations (generally those affecting 1,000 or more workers) in manufacturing and selected nonmanufacturing industries. The latter exclude construction, the service trades, finance, and government.

Source: Department of Labor.

Further evidence of this decline in the magnitude of wage increases is presented in Table 24. This table shows, for 1959-61, an increase in the number of workers affected by zero or negative wage changes and a decline in the number of workers receiving large percentage wage increases in major negotiations. The percentage of employees receiving wage increases of 3 1/2 percent or more declined from 64 percent in 1959 to 35 percent in 1961.

Smaller percentage increases in hourly wages do not necessarily imply smaller percentage increases in real wages. In recent years, annual increases in consumer prices have tended to become smaller and thus have offset, to some extent, lower rates of increase in adjusted hourly earnings and total hourly compensation in manufacturing.
### Table 24: Employees affected by major collective bargaining negotiations, by wage change, 1959–61

<table>
<thead>
<tr>
<th>Wage change</th>
<th>1959</th>
<th>1960</th>
<th>1961 1</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Thousands of employees</td>
<td>Percent of total</td>
<td>Thousands of employees</td>
</tr>
<tr>
<td>Total employees affected</td>
<td>3,343</td>
<td>100</td>
<td>4,508</td>
</tr>
<tr>
<td>No wage change</td>
<td>111</td>
<td>3</td>
<td>191</td>
</tr>
<tr>
<td>Decrease in wages</td>
<td>4</td>
<td>(1)</td>
<td>3</td>
</tr>
<tr>
<td>Increase in wages</td>
<td>3,228</td>
<td>97</td>
<td>4,314</td>
</tr>
<tr>
<td>Under 2% percent</td>
<td>254</td>
<td>8</td>
<td>994</td>
</tr>
<tr>
<td>2% and under 3%</td>
<td>497</td>
<td>18</td>
<td>1,151</td>
</tr>
<tr>
<td>3% and under 3½</td>
<td>2,144</td>
<td>64</td>
<td>1,783</td>
</tr>
<tr>
<td>Not specified or computed</td>
<td>34</td>
<td>1</td>
<td>11</td>
</tr>
</tbody>
</table>

1 Preliminary.
2 Less than 0.5 percent.

**NOTE.**—Data relate to changes negotiated during the year. They exclude changes negotiated in earlier years (i.e., deferred increases) and cost-of-living escalator adjustments. Data are limited to major collective bargaining situations (generally those affecting 1,000 or more workers) in manufacturing and selected nonmanufacturing industries. The latter exclude construction, the service trades, finance, and government.

Detail will not necessarily add to totals because of rounding.

Source: Department of Labor.

For example, in 1956–57, a 5.1 percent rise in adjusted hourly earnings (as shown in Table 22) was translated into an increase of only 1.7 percent in real adjusted hourly earnings because consumer prices rose by 3.4 percent. In 1959–60, on the other hand, money earnings increased by only 3.3 percent, but real earnings rose by 1.8 percent because of a slower rise in consumer prices. Similarly, total hourly compensation in money terms increased by 6.0 percent in 1956–57 and by only 4.1 percent in 1958–59; however, as a result of differences in price movements, the percentage rise in real compensation was greater in the second period than in the first.

The recent slowing down in the rates of increase of money wages may signify a gradual weakening of some of the cost pressures in the economy. However, the continuation of this trend is by no means certain. With long-term contracts, the industries affected by negotiations vary considerably from year to year, and the behavior of average wage rates in any year may be fortuitously influenced by this consideration. Thus, in 1960, negotiations were concluded in basic steel; in 1961 new long-term agreements were negotiated in automobiles, automotive parts, meat-packing, farm equipment, and construction. In 1962 major contracts will expire in basic steel, aluminum, fabricated metals, construction, aircraft, airlines, and the maritime industry. It must also be remembered that the period 1957–61 was characterized by relatively high rates of unemployment; the test of wage behavior in a period characterized by stronger demand for labor is still ahead.

**The shares of wages and profits.** Employee compensation as a percent of corporate sales rose somewhat between the immediate postwar years and 1953–54, but since then the employee share has been below the 1953–54 high with no clear trend either up or down. This is shown in Table 25.
**Table 25.—Relation of employee compensation, profits, and capital consumption allowances to sales: All private corporations, 1947–61**

<table>
<thead>
<tr>
<th>Period</th>
<th>Employee compensation</th>
<th>Profits</th>
<th>Capital consumption allowances</th>
<th>Profits after taxes plus capital consumption allowances</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Percent of sales</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Before taxes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1947</td>
<td>23.3</td>
<td>8.3</td>
<td>6.6</td>
<td>1.8</td>
</tr>
<tr>
<td>1948</td>
<td>23.2</td>
<td>8.3</td>
<td>7.7</td>
<td>5.1</td>
</tr>
<tr>
<td>1949</td>
<td>23.7</td>
<td>6.9</td>
<td>7.4</td>
<td>4.1</td>
</tr>
<tr>
<td>1950</td>
<td>23.6</td>
<td>9.2</td>
<td>8.0</td>
<td>5.0</td>
</tr>
<tr>
<td>1951</td>
<td>23.2</td>
<td>8.4</td>
<td>8.1</td>
<td>3.8</td>
</tr>
<tr>
<td>1952</td>
<td>24.3</td>
<td>7.1</td>
<td>7.3</td>
<td>3.2</td>
</tr>
<tr>
<td>1953</td>
<td>25.3</td>
<td>7.1</td>
<td>6.9</td>
<td>3.2</td>
</tr>
<tr>
<td>1954</td>
<td>25.3</td>
<td>6.3</td>
<td>6.3</td>
<td>3.0</td>
</tr>
<tr>
<td>1955</td>
<td>23.7</td>
<td>7.2</td>
<td>6.9</td>
<td>3.6</td>
</tr>
<tr>
<td>1956</td>
<td>24.5</td>
<td>6.5</td>
<td>6.4</td>
<td>3.4</td>
</tr>
<tr>
<td>1957</td>
<td>24.2</td>
<td>6.1</td>
<td>5.9</td>
<td>3.0</td>
</tr>
<tr>
<td>1958</td>
<td>24.2</td>
<td>5.4</td>
<td>5.4</td>
<td>2.6</td>
</tr>
<tr>
<td>1959</td>
<td>24.2</td>
<td>6.3</td>
<td>6.2</td>
<td>3.0</td>
</tr>
<tr>
<td>1960</td>
<td>24.7</td>
<td>5.8</td>
<td>5.9</td>
<td>2.8</td>
</tr>
<tr>
<td>1961</td>
<td>24.5</td>
<td>5.8</td>
<td>5.9</td>
<td>2.8</td>
</tr>
</tbody>
</table>

1 Preliminary estimates by Council of Economic Advisers.

**Note.**—The sum of compensation of employees, profits, and capital consumption allowances is a comparatively small percentage of sales because the latter includes all sales made by firms to other firms in successive stages of the production process, and, therefore, reflects a large amount of duplication. The comparative relations shown here would remain unaltered, however, if they were calculated on the basis of unduplicated sales.

Source: Department of Commerce (except as noted).

Corporate profits after taxes as a share of corporate sales were at their highest level in the 1947–50 period, when they were between 4.1 and 5.1 percent annually. Since 1951, the profit-after-tax share has been lower, fluctuating between 2.6 and 3.6 percent. Throughout the period, the profits share has shown a clear tendency to dip in periods of high unemployment and unutilized capacity.

A number of forces were involved in the behavior of profits. Unusually high inventory gains resulting from bursts of excess demand inflation swelled the profits share in 1947–48 and 1950; this can be seen in Table 25 by comparing corporate profits before taxes with profits before taxes plus inventory valuation adjustment. The rate of Federal corporate income taxation was increased in two steps from a level of 38 percent in 1947 to 52 percent in 1951, where it stands today; also, an excess profits tax was in effect from 1951 to 1953. Failure of the economy since the first half of 1957 to reach full employment has tended to depress the profits share in recent years.

Corporate capital consumption allowances (principally depreciation charges) have risen steadily throughout the postwar period as a share of corporate sales. One explanation of this trend is the fact that depreciation charges immediately after the war were based upon prewar prices of capital goods, and were thus further out of alignment with the replacement cost of business plant and equipment than they are today. In other words, as
compared with recent years, corporate profits in the earlier postwar years were relatively overstated and depreciation charges relatively understated. Also, the rise in depreciation charges is related to the Korean accelerated tax amortization program, and to the more generous depreciation formula enacted in the Revenue Act of 1954.

Corporate profits after taxes plus capital consumption allowances—"cash flow"—have shown considerable stability in relation to sales, particularly if allowance is made for the large inventory gains of 1947-48 and 1950. This is shown in the last column of Table 25. Cash flow is of course not the same as net profits; only a part of it is return on investment, and the remainder is an element of cost. But cash flow is a significant measure as an indication of potential availability of internally generated funds for the financing of investment.

**THE OUTLOOK FOR PRICES**

Although over-all excess demand is unlikely to develop in 1962 and cost-price developments in the past year were favorable to continued price stability, the economic future can never be predicted with certainty. Unexpected inflationary pressures could emerge from any one of several sources: scare-buying induced by a national security crisis, the emergence of major bottlenecks caused by shifts in the pattern of demand, price increases for imported raw materials, exercise of market power by management or labor to increase their shares of the national income, or other causes which lie at least within the realm of possibility.

Nevertheless, a review of the relevant statistical and analytical evidence gives some grounds for optimism on the outlook for price behavior in the months ahead—though the evidence cannot, of course, be conclusive.

Changes in the wholesale price index are more closely related to our international competitiveness than are changes in the consumer price index or the GNP implicit price index. The consumer price index is heavily influenced by changes in the prices of consumer services and in wholesale and retail margins, which do not directly affect our international trade, and it does not encompass producers' durable equipment, which is a major component of our foreign trade. On the other hand, the all-inclusive GNP implicit price index includes major components which do not enter directly into international trade, such as consumer services and government services. As noted earlier in this chapter, stability in the wholesale price index is likely to be associated with a slow rise in the consumer price index and a slightly greater rise in the GNP implicit price index.

At the present time, we are on the plateau of a period of price stability. Wholesale prices have been stable for over 3½ years, and wholesale industrial prices (excluding farm and food prices) have been stable for more than 2½ years. Both the wholesale price index and wholesale industrial prices were lower in December 1961 than at the cyclical trough in February.
This was the first of the four postwar recoveries in which wholesale industrial prices fell during the first 10 months of recovery.

Recent wage changes have been consistent with these price developments. As indicated earlier, annual wage increases in manufacturing have been declining for several years. The index of wage and salary cost per unit of output in manufacturing changed little from the cyclical peak in July 1957 to the peak in May 1960; by contrast, there were substantial peak-to-peak increases from 1948 to 1953 and from 1953 to 1957.

Such encouragement as may be derived from these recent price and wage trends must be tempered by the realization that they do not provide full protection for fixed-income recipients, and relate mainly to a period characterized by excess unemployment and productive capacity. The U.S. economy last experienced full employment in the first half of 1957; the recovery of 1958–60 stopped well short of full employment. While some significance can be attached to the fact that adjusted hourly earnings in manufacturing increased slightly less in 1959, a year of recovery, than in 1958, a cyclical trough year, and from the further fact that wholesale industrial prices fell during the 1961 recovery, the behavior of wages and prices in a period of sustained slack is an insufficient basis for inferences about price-wage behavior when the economy is moving up toward full employment.

Other considerations provide somewhat firmer grounds for optimism. As indicated in the analysis of Chapter 1, the continued recovery of the economy in 1962 is not likely to create major supply bottlenecks or to reach a state of over-all excess demand. The supply outlook for major imported raw materials does not suggest that an inflationary stimulus will originate in this quarter.

Foreign competition in the last few years has injected a powerful price-restraining force into the U.S. economy. We are now faced with sharp competition from imports in our domestic markets and from the exports of other industrial countries in our traditional export markets. Competition of any kind, internal or external, provides strong discipline for prices; the effects of foreign competition are stronger than might be suggested by the absolute size of foreign trade in our economy. The response to import competition itself tends to limit imports, so that the volume of realized imports is not a full measure of the force exerted by foreign competition. Moreover, conventional views as to appropriate shares of markets have great weight in pricing and other decisions. The number of foreign automobiles imported never amounted to as much as 11 percent of sales in the United States, and yet they helped to bring about a radical change in the design and marketing policy of a great industry.

The commodities component of the consumer price index, which in the last few years has mirrored the stability in the wholesale price index, is likely to continue to follow the course of wholesale prices in the months ahead. The services component, which has risen steadily since the war
will probably continue to do so. There are some favorable signs, however, which may indicate a slowing down in the rise of the prices of services. The great postwar expansion in the housing supply and higher vacancy rates seem to have slowed down the rise in rents. Also, movements in the rates charged by public utilities subject to rate regulation should reflect increasingly the narrowing of the gap between original cost and replacement cost of capital goods included in the rate base.

The slowing down since 1957 in the upward creep of consumer prices has reduced the effects on wages of cost of living escalator provisions in labor contracts, and may moderate somewhat the pressure of employees for large wage increases. It is also worthy of note that escalator provisions have been eliminated from, or modified in, a number of collective bargaining agreements.

Developments in the steel industry in 1961 were propitious for the continuation of price stability. Steel prices at the end of the year were slightly below the level of the end of 1958. This was a striking shift in trend for an industry in which prices had risen at the average rate of 5.8 percent a year from 1940 to 1958.

In early 1960, the steel industry, after a long strike, reached a wage settlement with the Steelworkers Union which provided for an estimated 3.7 percent annual increase in employment cost per worker. Though still somewhat above the over-all trend rate of productivity increase, this was a considerably smaller settlement than the 1956 contract, the cost of which was estimated at 8 percent a year.

Under the 1960 contract, a wage increase was scheduled to take effect on October 1, 1961. Confronted on one side with increasing foreign competition, stronger rivalry with substitutes, and intraindustry price shading, and on the other with an increase in wage rates, steel companies were reported in the press to be weighing the desirability of an October 1 price increase. In this setting, the President on September 6 addressed a letter to the heads of the 12 largest steel companies. Urging them to preserve price stability, the President stressed the damaging impact of a steel price increase on the balance of payments. “Steel is a bellwether,” he said, “as well as a major element in industrial costs. A rise in steel prices would force price increases in many industries and invite price increases in others.”

The President said:

In emphasizing the vital importance of steel prices to the strength of our economy, I do not wish to minimize the urgency of preventing inflationary movements in steel wages. I recognize, too, that the steel industry, by absorbing increases in employment costs since 1958, has demonstrated a will to halt the price-wage spiral in steel. If the industry were now to forego a price increase, it would enter collective bargaining negotiations next spring with a record of three and a half years of price stability. It would clearly then be the turn of the labor representatives to limit wage demands to a level consistent with continued price stability. The moral position of the steel industry next spring—and its claim to the support of public opinion—will be strengthened by the exercise of price restraint now.
A week later, the President addressed a letter to the President of the United Steelworkers of America. Referring to the forthcoming collective bargaining negotiations, the President urged “a labor settlement within the limits of advances in productivity and price stability.” The President expressed his confidence that “we can rely upon the leadership and members of the Steelworkers Union to act responsibly in the wage negotiations next year in the interests of all of the American people.”

At the end of the year, steel prices had not been raised.

All of these considerations suggest that a resumption of inflation in the course of the economic expansion foreseen for 1962 is not inevitable. As the year opens, the atmosphere is favorable for reasonable price stability. Whether this atmosphere is preserved or dissipated will depend on the wisdom of Government, business, and labor, in evolving policies affecting prices and costs.

**Policies Affecting Price Behavior**

*The Setting*

The over-all stability of prices should be achieved in a manner consistent with the flexible response of individual prices and wage rates to changes in cost and demand within an environment of dynamic competition. Thus, government policies to promote price stability must work to maintain and increase the freedom of the private economy, not to limit it. In peacetime, attempts to stabilize prices through the imposition of direct wage and price controls or through interference with the rights of employees to organize and bargain collectively are unacceptable. Also unacceptable are policies which pursue price stability without regard for the effects on employment, production, and purchasing power. Prices might be stabilized in an underemployed economy; but to accept heavy unemployment and persistent slack as the necessary cost of price stability is to undermine the vitality and flexibility of the economy and to reduce American strength.

Competitive behavior throughout the economy involves more than rivalry among firms selling similar products in a single market; it also involves hard bargaining between firms buying and selling from each other and between firms and unions. Abridgement of competition may be evidenced as much in permissive wage increases which are simply passed along in higher prices as in agreements among firms to divide markets.

Public policies to encourage economy-wide competition not only contribute to the goal of price stability; they also promote efficiency and the advance of productivity. Hence, such policies serve both the goal of economic growth and the goal of balance of payments equilibrium. In addition, such policies have an independent justification in that they make the economy more responsive to the demands of consumers and thereby improve the qualitative nature of the output generated by the economy at rising levels of activity. Improving the range of consumer choices is an important facet of economic progress, and one that gives ultimate meaning to policies of full employment and economic growth.
Policies to Foster Market Competition

Competition in product markets is promoted by an increase in the number and diversity of market alternatives available and by the removal of anticompetitive restrictions on business behavior. Examples of the former are reduction of import barriers and encouragement of new and growing businesses. Examples of the latter are attempts to halt tendencies toward monopolization and to eliminate collusive agreements among firms through antitrust policy.

Reduction of import barriers widens and strengthens competition in domestic markets. The experience of the European Common Market has demonstrated clearly that a broadened scope for international competition tends to spur cost reduction and innovation and to stimulate economic vitality. Two factors have been of paramount importance in the success of this experiment. First, the terms of the Common Market agreement were such that producers understood well in advance the scope and timetable of coming tariff reductions and thus were able to prepare for them. Second, because free trade policies were pursued in an environment of rapid economic growth, increased foreign competition was not so much a threat to existing markets as an incentive to respond to new profit-making opportunities. Similar advantages can be reaped for the United States through the adoption of the new foreign trade expansion program proposed by the President. Although imports are now, and will remain, a much smaller proportion of sales in our market than in Europe, modest increases in imports can yield competitive benefits to the U.S. economy out of proportion to their size.

Public policy toward small business has as its purpose the strengthening of the small business sector of the economy and the removal of artificial and discriminatory barriers to the profitability and growth of small firms. Although some of the limitations upon small business participation in the economy arise from technological considerations and true cost economies associated with large size, important limitations arise from direct discrimination and from lack of access to capital, of widespread market contact, and of information. Programs which redress these imbalances of competitive advantage make possible the salutary competition of new and growing enterprises throughout the economy. Small firms are often particularly well-situated to perceive changing market needs and production possibilities, and to take the lead in adapting to them, thus contributing to the efficiency and growth of the economy.

Antitrust policies promote market competition by halting tendencies toward monopolization and by eliminating unfair methods of competition and illegal restraints upon trade. Antimerger actions are designed to prevent the disappearance of independent competitors and the consequent impairment of competition. Checking monopolistic price increases during periods of expanded demand is facilitated both by the continuing effort to prevent the increase of business concentration and by the detection
and prosecution of market conspiracies. The dissolution of such conspiracies is especially important during periods of economic expansion, for it is during such periods that potential competitors find it easiest to reach agreement on market divisions and price increases. An important by-product of corrective antitrust action is the deterrent effect which successful prosecution has upon other potential offenders. To the extent that potential anticompetitive developments are deterred and existing competitive elements in the economy preserved and strengthened, antitrust policy contributes to the maintenance of competition and price stability far more than a simple list of prosecutions would indicate.

GUIDEPOSTS FOR NONINFLATIONARY WAGE AND PRICE BEHAVIOR

There are important segments of the economy where firms are large or employees well-organized, or both. In these sectors, private parties may exercise considerable discretion over the terms of wage bargains and price decisions. Thus, at least in the short run, there is considerable room for the exercise of private power and a parallel need for the assumption of private responsibility.

Individual wage and price decisions assume national importance when they involve large numbers of workers and large amounts of output directly, or when they are regarded by large segments of the economy as setting a pattern. Because such decisions affect the progress of the whole economy, there is legitimate reason for public interest in their content and consequences. An informed public, aware of the significance of major wage bargains and price decisions, and equipped to judge for itself their compatibility with the national interest, can help to create an atmosphere in which the parties to such decisions will exercise their powers responsibly.

How is the public to judge whether a particular wage-price decision is in the national interest? No simple test exists, and it is not possible to set out systematically all of the many considerations which bear on such a judgment. However, since the question is of prime importance to the strength and progress of the American economy, it deserves widespread public discussion and clarification of the issues. What follows is intended as a contribution to such a discussion.

Mandatory controls in peacetime over the outcomes of wage negotiations and over individual price decisions are neither desirable in the American tradition nor practical in a diffuse and decentralized continental economy. Free collective bargaining is the vehicle for the achievement of contractual agreements on wages, fringes, and working conditions, as well as on the "web of rules" by which a large segment of industry governs the performance of work and the distribution of rewards. Similarly, final price decisions lie—and should continue to lie—in the hands of individual firms. It is, however, both desirable and practical that discretionary decisions on wages and prices recognize the national interest in the results. The guideposts
suggested here as aids to public understanding are not concerned primarily with the relation of employers and employees to each other, but rather with their joint relation to the rest of the economy.

**Wages, prices, and productivity.** If all prices remain stable, all hourly labor costs may increase as fast as economy-wide productivity without, for that reason alone, changing the relative share of labor and nonlabor incomes in total output. At the same time, each kind of income increases steadily in absolute amount. If hourly labor costs increase at a slower rate than productivity, the share of nonlabor incomes will grow or prices will fall, or both. Conversely, if hourly labor costs increase more rapidly than productivity, the share of labor incomes in the total product will increase or prices will rise, or both. It is this relationship among long-run economy-wide productivity, wages, and prices which makes the rate of productivity change an important benchmark for noninflationary wage and price behavior.

Productivity is a *guide* rather than a *rule* for appraising wage and price behavior for several reasons. First, there are a number of problems involved in measuring productivity change, and a number of alternative measures are available. Second, there is nothing immutable in fact or in justice about the distribution of the total product between labor and nonlabor incomes. Third, the pattern of wages and prices among industries is and should be responsive to forces other than changes in productivity.

**Alternative measures of productivity.** If the rate of growth of productivity over time is to serve as a useful benchmark for wage and price behavior, there must be some meeting of minds about the appropriate methods of measuring the trend rate of increase in productivity, both for industry as a whole and for individual industries. This is a large and complex

<table>
<thead>
<tr>
<th>TABLE 26.—Annual rates of growth of output per man-hour, 1909 to 1960</th>
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<tr>
<td><strong>Industry series</strong></td>
<td><strong>Average annual percentage change</strong> <em>&lt;sup&gt;1&lt;/sup&gt;</em>*</td>
</tr>
<tr>
<td>Total private economy</td>
<td>2.4</td>
</tr>
<tr>
<td>Nonagriculture</td>
<td>2.1</td>
</tr>
<tr>
<td>Nonmanufacturing</td>
<td>(3)</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>(3)</td>
</tr>
<tr>
<td>Manufacturing corrected for varying rates of capacity utilization</td>
<td>(3)</td>
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</tbody>
</table>

*<sup>1</sup> Computed from least squares trend of the logarithms of the output per man-hour indexes. See Table B-31 for indexes for 1947–60.
*<sup>2</sup> Not available.

Sources: Department of Labor and Council of Economic Advisers.
subject and there is much still to be learned. The most that can be done at present is to give some indication of orders of magnitude, and of the range within which most plausible measures are likely to fall (Table 26).

There are a number of conceptual problems in connection with productivity measurement which can give rise to differences in estimates of its rate of growth. Three important conceptual problems are the following:

1. Over what time interval should productivity trends be measured? Very short intervals may give excessive weight to business-cycle movements in productivity, which are not the relevant standards for wage behavior. The erratic nature of year-to-year changes in productivity is shown in Chart 14. Very long intervals may hide significant breaks in trends; indeed, in the United States—and in other countries as well—productivity appears to have risen more rapidly since the end of the second World War than before. It would be wholly inappropriate for wage behavior in the 1960's to be governed by events long in the past. On the other hand, productivity in the total private economy appears to have advanced less rapidly in the second half of the postwar period than in the first.

**CHART 14**

Indexes of Output per Man-Hour

INDEX, 1947-49 = 100 (Ratio scale)

NOTE: MAN-HOURS ESTIMATES BASED PRIMARILY ON ESTABLISHMENT DATA.

SOURCE: DEPARTMENT OF LABOR.
(2) Even for periods of intermediate length, it is desirable to segregate the trend movements in productivity from those that reflect business-cycle forces. Where the basic statistical materials are available, this problem can be handled by an analytical separation of trend effects and the effects of changes in the rate of capacity utilization.

(3) Even apart from such difficulties, there often exist alternative statistical measures of output and labor input. The alternatives may differ conceptually or may simply be derived from different statistical sources. A difficult problem of choice may emerge, unless the alternative measures happen to give similar results.

Selected measures of the rate of growth of productivity in different sectors of the economy for different time periods are shown in Table 26. Several measures are given because none of the single figures is clearly superior for all purposes.

The share of labor income. The proportions in which labor and non-labor incomes share the product of industry have not been immutable throughout American history, nor can they be expected to stand forever where they are today. It is desirable that labor and management should bargain explicitly about the distribution of the income of particular firms or industries. It is, however, undesirable that they should bargain implicitly about the general price level. Excessive wage settlements which are paid for through price increases in major industries put direct pressure on the general price level and produce spillover and imitative effects throughout the economy. Such settlements may fail to redistribute income within the industry involved; rather they redistribute income between that industry and other segments of the economy through the mechanism of inflation.

Prices and wages in individual industries. What are the guideposts which may be used in judging whether a particular price or wage decision may be inflationary? The desired objective is a stable price level, within which particular prices rise, fall, or remain stable in response to economic pressures. Hence, price stability within any particular industry is not necessarily a correct guide to price and wage decisions in that industry. It is possible, however, to describe in broad outline a set of guides which, if followed, would preserve over-all price stability while still allowing sufficient flexibility to accommodate objectives of efficiency and equity. These are not arbitrary guides. They describe—briefly and no doubt incompletely—how prices and wage rates would behave in a smoothly functioning competitive economy operating near full employment. Nor do they constitute a mechanical formula for determining whether a particular price or wage decision is inflationary. They will serve their purpose if they suggest to the interested public a useful way of approaching the appraisal of such a decision.

If, as a point of departure, we assume no change in the relative shares of labor and nonlabor incomes in a particular industry, then a general guide

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may be advanced for noninflationary wage behavior, and another for non-
inflationary price behavior. Both guides, as will be seen, are only first
approximations.

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. General acceptance of
this guide would maintain stability of labor cost per unit of output for the
economy as a whole—though not of course for individual industries.

The general guide for noninflationary price behavior calls for price reduc-
tion 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.

These are advanced as general guideposts. To reconcile them with ob-
jectives of equity and efficiency, specific modifications must be made to
adapt them to the circumstances of particular industries. If all of these
modifications are made, each in the specific circumstances to which it
applies, they are consistent with stability of the general price level. Public
judgments about the effects on the price level of particular wage or price
decisions should take into account the modifications as well as the general
guides. The most important modifications are the following:

(1) Wage rate increases would exceed the general guide rate in an
industry which would otherwise be unable to attract sufficient labor; or in
which wage rates are exceptionally low compared with the range of wages
earned elsewhere by similar labor, because the bargaining position of
workers has been weak in particular local labor markets.

(2) Wage rate increases would fall short of the general guide rate in an
industry which could not provide jobs for its entire labor force even in
times of generally full employment; or in which wage rates are exceptionally
high compared with the range of wages earned elsewhere by similar labor,
because the bargaining position of workers has been especially strong.

(3) Prices would rise more rapidly, or fall more slowly, than indicated
by the general guide rate in an industry in which the level of profits was
insufficient to attract the capital required to finance a needed expansion in
capacity; or in which costs other than labor costs had risen.

(4) Prices would rise more slowly, or fall more rapidly, than indicated by
the general guide in an industry in which the relation of productive capacity
to full employment demand shows the desirability of an outflow of capital
from the industry; or in which costs other than labor costs have fallen;
or in which excessive market power has resulted in rates of profit substan-
tially higher than those earned elsewhere on investments of comparable risk.
It is a measure of the difficulty of the problem that even these complex guideposts leave out of account several important considerations. Although output per man-hour rises mainly in response to improvements in the quantity and quality of capital goods with which employees are equipped, employees are often able to improve their performance by means within their own control. It is obviously in the public interest that incentives be preserved which would reward employees for such efforts.

Also, in connection with the use of measures of over-all productivity gain as benchmarks for wage increases, it must be borne in mind that average hourly labor costs often change through the process of up- or down-grading, shifts between wage and salaried employment, and other forces. Such changes may either add to or subtract from the increment which is available for wage increases under the over-all productivity guide.

Finally, it must be reiterated that collective bargaining within an industry over the division of the proceeds between labor and nonlabor income is not necessarily disruptive of over-all price stability. The relative shares can change within the bounds of noninflationary price behavior. But when a disagreement between management and labor is resolved by passing the bill to the rest of the economy, the bill is paid in depreciated currency to the ultimate advantage of no one.

It is no accident that productivity is the central guidepost for wage settlements. Ultimately, it is rising output per man hour which must yield the ingredients of a rising standard of living. Growth in productivity makes it possible for real wages and real profits to rise side by side.

Rising productivity is the foundation of the country's leadership of the free world, enabling it to earn in world competition the means to discharge its commitments overseas. Rapid advance of productivity is the key to stability of the price level as money incomes rise, to fundamental improvement in the balance of international payments, and to growth in the Nation's capacity to meet the challenges of the 1960's at home and abroad. That is why policy to accelerate economic growth stresses investments in science and technology, plant and equipment, education and training—the basic sources of future gains in productivity.