# THE ANNUAL REPORT
# OF THE
# COUNCIL OF ECONOMIC ADVISERS

## LETTER OF TRANSMITTAL

COUNCIL OF ECONOMIC ADVISERS,
*Washington, D.C., January 21, 1965.*

THE PRESIDENT:

SIR: The Council of Economic Advisers herewith submits its Annual Report, January 1965, in accordance with Section 4(c) (2) of the Employment Act of 1946.

Respectfully,

GARDNER ACKLEY,
*Chairman.*

OTTO ECKSTEIN

ARTHUR M. OKUN

## CONTENTS

APPENDIXES:



## List of Tables and Charts

*Tables*

*Charts*

## INTRODUCTION

Speaking at the University of Michigan last May, President Johnson declared that in the time of his listeners

> . . . we have the opportunity to move not only toward the rich society and the powerful society, but upward to the Great Society. The Great Society rests on abundance and liberty for all. It demands an end to poverty and racial injustice, to which we are totally committed in our time. But that is just the beginning. The Great Society is a place where every child can find knowledge to enrich his mind and to enlarge his talents. It is a place where leisure is a welcome chance to build and reflect, not a feared cause of boredom and restlessness. It is a place where the city of man serves not only the needs of the body and the demands of commerce, but the desire for beauty and the hunger for community.
>
> It is a place where man can renew contact with nature. It is a place which honors creation for its own sake and for what it adds to the understanding of the race. It is a place where men are more concerned with the quality of their goals than the quantity of their goods. . . .

The President's vision extends far beyond the material goals that are the immediate concern of economic policy. Yet pursuit of our society's human goals sharpens anew the challenge to economic policy.

These goals require a growing abundance, widely shared. They are not served by recessions, stagnation, or wasted resources. Maintaining full employment and expanding prosperity with stable prices are tasks long since assigned to economic policy by the Employment Act of 1946.

A nation which demands an end to poverty cannot permit whole regions, counties, or neighborhoods to decay. It cannot ignore its children and its aged, its sick and its handicapped. It cannot let anyone be deprived of needed medical care because he cannot pay. Economic policy must support human compassion in the attack on poverty.

Education of every human being to his full potential is a central goal. Workers must be equipped for today's tasks, their children prepared for tomorrow's. Even more important, all citizens must be able to enjoy and understand—and have the opportunity also to advance and enrich—the cultural, moral, and scientific traditions of their civilization. Economic policy cannot make men wise, sympathetic, and cultured. But it can find ways to finance their schools, libraries, museums, and galleries.

The progress of technology has made us an urban society. We would not turn the clock back if we could. Economic policy cannot make our cities into places of beauty. But it can make them more efficient. It can help to provide attractive neighborhoods, clean streets, green parks, fresh air, and pure water. It can help to make travel between cities, within them, and between them and the countryside fast and efficient. It can help to protect the natural beauty of land and water against the inroads of commerce.

We seek a world in which men, women, and children are healthy in mind and body. Economists cannot cure the illnesses of man. But they can devise ways to support hospitals, treatment centers, medical research, and the spread of the latest knowledge.

Our goal is a free society, where men and women control their own destinies, where they decide for themselves where and how to spend their lives, their incomes, their time—free from governmental or private coercion. We seek to make opportunities equally open to all. Economic policy can enlarge freedom by breaking down artificial barriers to mobility and choice, by expanding the flexibility and responsiveness of production to changing wants, by encouraging diversity, and by preserving and increasing the rewards to originality and enterprise.

Relating economic policy to broader human goals is not an altogether new orientation for the Council. Three years ago, it began its Annual Report with these words:

> 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.

Under the Employment Act, the basic duty of the Council of Economic Advisers is to advise the President on measures to achieve the goals of "maximum employment, production, and purchasing power." If the economy performs well by the standards of the Act, the general climate will be hospitable to the many specific activities, public and private, which will advance our human goals.

In 1964, the United States passed a watershed in economic policy. After lengthy debate, this country boldly reduced taxes to accelerate expansion and reduce unemployment. The effects were immediate and telling. A mild expansion—which might soon have lapsed into tired decline—picked up its pace, and at year end showed every sign of long and vigorous life.

The lessons of 1964 will not soon be lost:

—Fiscal policy can sustain growth and raise spending power to the levels needed to use our resources more fully.

—Price stability can be maintained during a strong and balanced expansion.

—The balance of payments can improve in a period of prosperity.

A new era for economic policy is at hand. A wide consensus of responsible opinion now recognizes that Federal fiscal policy must be geared to keep the economy moving ahead.

This Annual Report begins with a review of the recent and current performance of our economy. It attempts to dissect the unprecedentedly long and healthy expansion of the past four years, discovering what factors and policies, public and private, have contributed to our progress. It finds that the fiscal policies of the past four years—and especially the tax cut enacted last February—have played a major part in building and buttressing our prosperity; that the progressive and flexible monetary policies of these four years have also contributed both to domestic prosperity and to our improving international balance of payments; and that responsible wage and price policies have been an important source of strength.

Chapter 2 presents the Council's annual forecast for the year ahead. It finds grounds for moderate optimism, with respect to both output and prices. But it sees unwanted idleness remaining as a major problem throughout the year. It sees more rapid growth of our total capacity to produce—primarily as a result of a faster growth of our labor force. While the longer-term prospects suggest gradual strengthening in private demand over the next decade, fiscal and monetary policies are, for the next few years, likely to face the continuing challenge of providing stimulus to markets rather than of restraining excessive growth of demand.

Measures are considered which could defend against possible recession; the guideposts for responsible wage and price behavior are reaffirmed; and the policies needed to move toward better international balance for the United States and a better world economic order are reviewed.

Chapters 1 and 2 are thus primarily concerned with the foundations of over-all abundance on which the Great Society must rest.

Chapter 3 turns to consideration of some problems of the changing structure of our economy—ways to improve and extend flexibility and freedom, in the interests of faster growth and greater efficiency, as well as to assist individuals toward fuller realization of their own potentials.

Chapter 4 deals with a series of specific economic problems that must be overcome on the road to the Great Society, and with the policies necessary to attain these goals: improvement of our cities; the expansion of public services in education and health; a stepping-up of the war against poverty; and equality of opportunity.

Accelerating our progress toward the Great Society provides new and urgent tasks for economic policy. But the challenge comes at a time when the tools of economic policy are also becoming more refined, more effective, and increasingly freed from inhibitions imposed by traditions, misunderstanding, and doctrinaire polemics. In particular, the debates over fiscal policy that have accompanied the measures of the past several years have increased public understanding, moderated extreme views, narrowed the range of issues, and elevated the plane of discussion.

Economic policy-making is not yet and never will or should be a science, but it is becoming more scientific. Men will continue to differ about some of the goals of the Great Society. But they are perhaps coming to differ less about the economic measures that can best achieve particular objectives.

## Chapter 1

# The Sustained Expansion of 1961-64

AS 1965 BEGINS, most Americans are enjoying a degree of prosperity unmatched in their experience, or indeed in the history of their Nation. In 1964, some 70 million of them were at work, producing $622 billion worth of goods and services.

The gains of four years of uninterrupted economic expansion had brought fuller pay envelopes, greater sales, larger dividend checks, a higher standard of living, more savings, and a stronger sense of security than ever before. Over that period industrial production grew at an average annual rate of 7 percent, and the total output of all goods and services (valued in constant prices) increased at an average rate of 5 percent (Table 1). These gains brought jobs to 4 million more persons and raised total consumer income after taxes by 6 percent a year. And all this was accomplished with essentially stable prices.

That the extent and duration of these gains exceeded the two preceding postwar expansions can be seen from Chart 1. Indeed, in a few months, the duration of this expansion will have surpassed any other on record—except only the prolonged advance before and during World War II.

### AN OVER-ALL VIEW OF THE EXPANSION

This gratifying record reflects the strength and elasticity of the private economy, and its favorable response to a series of policy measures deliberately designed to invigorate it. The upturn in 1961 was quick and strong, in part through an early recovery of private demand and in part through forceful policy actions. Prompt steps to boost consumers' purchasing power, taken by President Kennedy's Administration, were later reinforced by increases in Government expenditures necessary to strengthen America's basic defenses and to achieve the precautionary buildup required by the Berlin crisis.

Following the rapid recovery, the outlook appeared favorable in early 1962. Many observers, recognizing that there were special explanations for the weakness and brevity of the recovery of 1958–60, expected a return of the vigorous expansionary strength of 1954–57. In fact, conditions had changed. The backlogs of demand for housing, consumer durable goods, and additions to manufacturing plant and equipment, which had existed

TABLE 1.—*Changes in selected measures of economic activity during the current expansion*

[Seasonally adjusted except as noted]

| Measure | 1961 I | 1964 IV | Absolute change | Percentage change: Total | Percentage change: Per year |
|---|---|---|---|---|---|
| | Billions of dollars, annual rate | | | | |
| Gross national product: | | | | | |
| Total: | | | | | |
| Current prices | 501.4 | 633.5 | 132.1 | 26.3 | 6.4 |
| 1964 prices | 524.9 | 629.4 | 104.5 | 19.9 | 5.0 |
| Private: | | | | | |
| Current prices | 452.1 | 568.4 | 116.3 | 25.7 | 6.3 |
| 1964 prices | 468.4 | 565.3 | 96.9 | 20.7 | 5.1 |
| | 1957–59=100 | | | | |
| Industrial production: | | | | | |
| Total | 103.7 | 134.4 | 30.7 | 29.6 | 7.2 |
| Manufacturing | 103.1 | 135.2 | 32.1 | 31.1 | 7.5 |
| Durable | 99.1 | 135.4 | 36.3 | 36.6 | 8.7 |
| | Millions of persons | | | | |
| Employment and unemployment: [1] | | | | | |
| Civilian labor force | 71.4 | 74.4 | 3.0 | 4.2 | 1.1 |
| Employment | 66.6 | 70.7 | 4.1 | 6.2 | 1.6 |
| Nonagricultural | 60.9 | 66.4 | 5.5 | 9.0 | 2.3 |
| *Unemployment rate (percent)* | *6.8* | *5.0* | *−1.8* | ---------- | ---------- |
| Private nonagricultural payroll employment | 45.0 | 49.1 | 4.1 | 9.2 | 2.4 |
| | Billions of dollars, annual rate | | | | |
| Personal income: | | | | | |
| Total (before taxes) | 407.2 | 502.2 | 95.0 | 23.3 | 5.8 |
| Wages and salaries | 271.5 | 339.9 | 68.4 | 25.2 | 6.2 |
| Disposable (after taxes) | 355.6 | 442.0 | 86.4 | 24.3 | 6.0 |
| Consumer purchasing power [2] | 355.6 | 424.6 | 69.0 | 19.4 | 4.8 |
| Corporate profits: | | | | | |
| Before taxes plus inventory valuation adjustment | 39.2 | [3] 58.1 | [3] 18.9 | [3] 48.2 | [3] 11.9 |
| After taxes | 19.5 | [3] 32.0 | [3] 12.5 | [3] 64.1 | [3] 15.2 |
| Corporate purchasing power [4] | 19.5 | [3] 31.1 | [3] 11.6 | [3] 59.5 | [3] 14.3 |
| | 1957–59=100, unadjusted | | | | |
| Prices: | | | | | |
| Consumer | 103.9 | [5] 108.6 | 4.7 | 4.5 | 1.2 |
| Wholesale | 101.0 | 100.8 | −.2 | −.2 | −.1 |

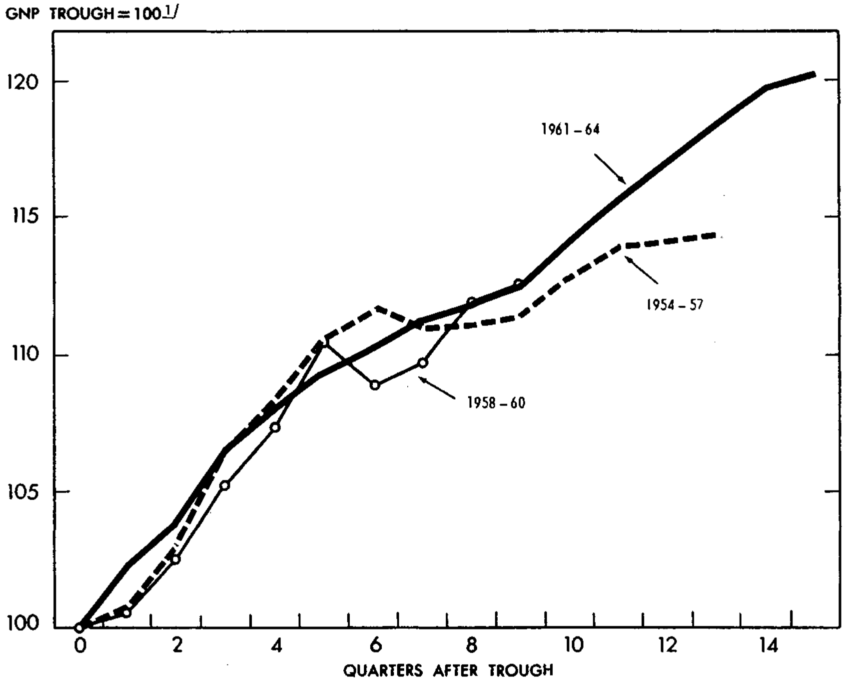
[1] Labor force data for 1961 I adjusted for comparability with data for 1964 IV.
[2] Disposable personal income (current prices) divided by the implicit price deflator of personal consumption expenditures on a 1961 I=100 base.
[3] Data for 1964 III and change from 1961 I to 1964 III.
[4] Corporate profits after taxes (current prices) divided by the implicit price deflator of "private nonresidential construction plus producers' durable equipment" on a 1961 I=100 base.
[5] Average of October–November data.

NOTE.—Detail will not necessarily add to totals because of rounding.

Sources: Department of Commerce, Department of Labor, Board of Governors of the Federal Reserve System, and Council of Economic Advisers.

Chart 1

## Real GNP in Three Postwar Expansions




1/ BASED ON SEASONALLY ADJUSTED DATA, IN CONSTANT PRICES.
TROUGH QUARTERS FOR GNP WERE 1954 II, 1958 I, AND 1961 I.
SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

in 1954–55, were gone. Even after the expansionary fiscal measures of 1961, the Federal budget remained more restrictive than it had been in the 1954–57 period. Holdings of liquid assets were considerably lower relative to income than in the years prior to 1955, partly as a result of years of tighter monetary policy.

In the course of 1962, the pace of expansion slowed. By mid-1962 it had become apparent that, given the level and structure of Federal tax rates, the strength of private demand would be insufficient to carry the economy up to full employment of its resources. Consequently, President Kennedy announced in August that he would propose a major tax bill in 1963, reducing the rates of personal income and corporate profits taxes from levels which had been determined in large part by the need to fight the postwar and Korean inflations. The year 1963 saw prolonged debate over this measure, and enactment came only in February 1964. But by mid-1963, increasing confidence that prosperity would be maintained with the aid of the expected tax cut, the continuing support of an expansionary monetary policy, the fuller response of business investment to the 1962 tax measures, and the strong demand for automobiles once again began to accelerate the pace of expansion. Thus, as the Revenue Act of 1964 became effective, the economy was already moving ahead strongly.

## THE ECONOMY IN 1964

In its Report a year ago, the Council of Economic Advisers found that ". . . the outlook this year calls for a significant acceleration in the growth of output. At the midpoint of the forecast range, current-dollar GNP for 1964 is estimated to increase 6½ percent above the level of 1963, and the real GNP, about 5 percent . . . the more rapid expansion of production in 1964 should lower the unemployment rate. By the end of the year, it is expected to fall to approximately 5 percent." These expectations were realized. Gross national product (GNP) for the year as a whole exceeded that of 1963 by 6½ percent, and the unemployment rate in December was 5.0 percent.

The optimistic forecast for 1964 depended on the tax cut, and its fulfillment is a measure of the tax cut's accomplishments.

Between the final quarter of 1963 and the final quarter of 1964, business fixed investment rose by 9 percent. This confidence in expanding markets proved to be justified. Strengthened by the tax cut, consumer spending rose exceptionally rapidly and steadily during the year. Gains of total production ran close to $10 billion a quarter, until the fourth quarter when strikes at General Motors and Ford plants reduced production and held down consumer purchases. But by year end, the effects of the strikes were overcome. Retail sales in December ran a strong 8½ percent above sales a year earlier. The dip in the growth of industrial production had been more than erased, and employment in December was 1.8 million above the same month in 1963.

These four years of expansion have demonstrated that the American economy is capable of sustained balanced growth in peacetime. No law of nature compels a free market economy to suffer from recessions or periodic inflations. As the postwar experience of Western Europe and Japan already indicates, future progress need not be interrupted even though its pace may vary from year to year. We need not judge the life expectancy of the current expansion by measuring the time it has already run. The economy is in good health, and its prospects for continued expansion are in no wise dimmed by the fact that the upswing began four years ago rather than one or two years ago.

## PROBLEMS UNSOLVED

The expansion of economic activity during the past four years has carried virtually every economic indicator to a new record level. But this in itself is no cause for complacency. In a growing economy, it should be a matter of course to set new records month by month and quarter by quarter; to be meaningful, economic achievements must be gauged against capabilities and objectives.

Unfortunately, the balanced growth of the U.S. economy in recent years, unlike the sustained progress of other industrial economies, has occurred at too low a level. The excessive unemployment and idle capacity with which the current U.S. expansion began have not yet been fully erased. Unemployment at 5.0 percent of the civilian labor force is far better than the 7 percent rate of spring 1961. But 5.0 percent represents 3.7 million persons seeking work. If unemployment today were at the interim target of 4 percent, the number without jobs would have fallen below 3 million, and the labor force would be considerably larger than it is today, as emerging job opportunities encouraged more people to seek work. Consumer incomes and corporate profits would both be considerably higher. The "gap" of \$25–\$30 billion that still remains between the Nation's actual output and its potential output would be closed. The size of this gap—4 percent of our current potential—is a measure of the primary challenge for economic policy: achieving maximum employment, production, and purchasing power.

A second challenge—not new, but more fully recognized than ever before—lies in the contrast between our great over-all prosperity and the poverty and misery which still afflict too many families, and in the contrast between our great material achievements and the quality of our private and public lives.

A third challenge of pressing importance lies in the fact that, despite considerable progress, we have not yet regained equilibrium in our balance of payments.

---

The remainder of this chapter has three main tasks: first, to dissect the character of the sustained expansion of 1961–64; second, to assess the contribution of fiscal and monetary policies to the successful record of these years; and, third, to review the accompanying changes in our international payments position and the policies that have contributed to the gains we have made.

## THE ANATOMY OF THE EXPANSION

The remarkable characteristic of the current expansion is not the degree to which it has carried us toward our objective of full employment. Previous expansions have done as well or better in this respect. Rather, its most remarkable feature is its durability. This can be attributed in important part to the balance maintained among the various components of private demand; to the balance maintained between production and sales, thus avoiding excessive inventory accumulation; to the balance maintained between the expansion of demand and the expansion of productive capacity to satisfy that demand; and to the balance maintained among wages, prices, and productivity. Imbalances in one or more of these respects brought earlier expansions to an end. Some ended when inventories became top-heavy; others when a major industry had expanded too fast, and its retrenchment was not offset elsewhere; still others when growth of demand generally failed to keep pace with growth of capacity. The key to sustained full employment lies in preserving balance as over-all demand moves closer to the economy's full capacity.

Since 1961, the expansion of demand has been persistent and pervasive, but production has stayed short of supply capabilities. Placement of orders has advanced only moderately ahead of production and shipments, so that unfilled orders have grown gradually. Capacity has expanded along with production, without bottlenecks or overbuilding.

Businesses have followed a prudent employment policy, avoiding both overstaffing and the need for sudden heavy hiring. This, in turn, partly explains the steady gains in productivity throughout the expansion. Increases in production have been large enough to utilize the net gain in the labor force and to make inroads into unemployment.

With no significant buildup of unfilled orders, and with production not making full use of capacity, price increases from generally excessive demand have remained remote. With wage increases matching productivity gains, labor costs per unit of output have remained unusually stable, and any general upward pressure of costs on prices has been avoided. Thus the purchasing power of personal and business incomes has risen steadily and strongly.

The patterns of year-to-year change in total GNP and in its several major expenditure components are shown in Table 2 and Chart 2. The most striking aspect is the renewed fast expansion between 1963 and 1964, following the distinct slowing down of growth that occurred between 1962 and 1963. The table shows that a major acceleration of consumption expendi-

TABLE 2.—*Changes in gross national product in the current expansion*

[Billions of dollars]

| Expenditure group | 1961 to 1962 | 1962 to 1963 | 1963 to 1964 [1] |
|---|---|---|---|
| Gross national product | 37.5 | 27.7 | 38.4 |
| Personal consumption expenditures | 19.5 | 18.2 | 24.2 |
| Nonconsumption expenditures | 18.0 | 9.5 | 14.2 |
| Residential construction | 2.5 | 1.6 | .8 |
| Private business fixed investment | 3.9 | 2.7 | 5.7 |
| Change in business inventories | 4.0 | −1.5 | −.7 |
| Net exports | −.6 | .4 | 2.3 |
| Government purchases of goods and services | 8.3 | 6.3 | 6.1 |
| Federal | 5.5 | 1.8 | .9 |
| State and local | 2.9 | 4.4 | 5.1 |

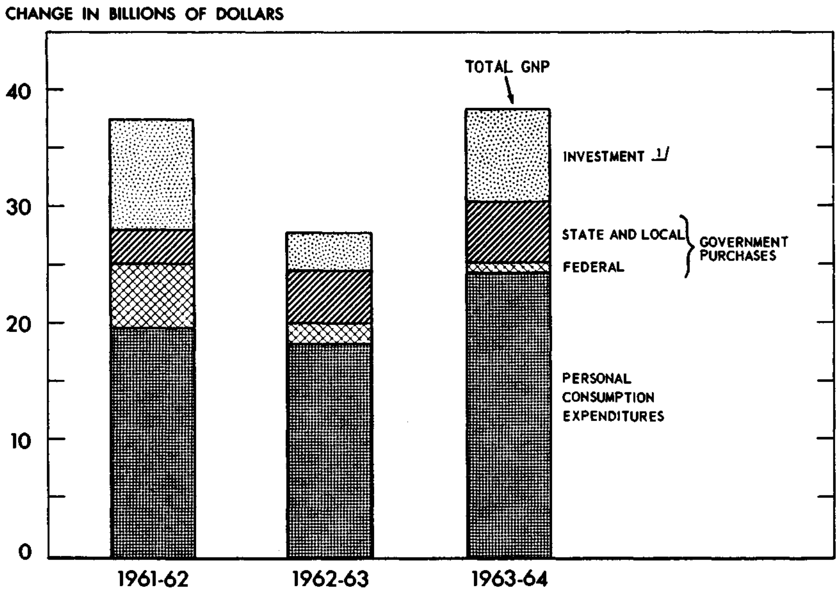
[1] Preliminary estimates.

NOTE.—Detail will not necessarily add to totals because of rounding.

Source: Department of Commerce.

Chart 2

## Changes in Gross National Product Since 1961




1/ GROSS PRIVATE DOMESTIC INVESTMENT AND NET EXPORTS.
SOURCE: DEPARTMENT OF COMMERCE.

tures, and a substantial rise in business fixed investment and State and local government spending, were the main elements in the faster expansion of 1964. It also shows that the slowdown in 1963 reflected a smaller growth of every element of spending except net exports and State and local outlays.

The following sections review in some detail the record of the expansion for each of the major categories of private expenditure. Then, the record is detailed in terms of the behavior of income shares; the contribution of credit; the pattern of wages, prices, and productivity; and the record of employment. Because of their importance in this expansion, the contributions of fiscal and monetary policies are reserved for separate treatment in the next major part of the chapter.

### THE DEPENDABLE CONSUMER

Consumers, in the aggregate, purchase roughly two-thirds of our total output. And when total output increases, the larger part of the increase is accounted for by consumer buying. Yet changes in consumer spending rarely provide the fundamental force behind large or prolonged expansions or contractions of output.

Mainly, consumers alter their total buying in response to variations in their total income after taxes (disposable income). Indeed, in each year since 1949, consumer spending has ranged between 92 percent and 94 percent of disposable income, averaging close to 93 percent.

This means that if we are to understand the main variations in consumer buying we must look to the sources of changes in disposable income.

Changes in disposable income usually reflect increases or decreases in total production, for the largest part of consumer income is earned from current production. Occasionally, however—and 1964 was a notable case—disposable income increases independently of production, particularly through alteration in consumer tax rates. Reduced tax rates leave available to consumers a larger part of the income that they earn from any given level of total output. The resulting increase in their buying then stimulates more production and, through higher incomes, still further increases in consumer buying and production. Just such a pattern of response to the 1964 tax cut is examined in more detail below.

In the absence of tax rate changes, the fundamental force moving total production ordinarily is found in changes in the total of *nonconsumption* expenditures—the building of new plants and the purchase of new machines, the accumulation of business inventories, the construction of new houses and apartments, net exports to foreign countries, and government purchases of goods and services.

Occasionally, to be sure, a shift in the intensity of consumer buying appears to be spontaneous—reflecting the typical consumer's mood of optimism or pessimism, his favorable or unfavorable response to new designs of the Diors of Detroit, or a sudden interest or loss of interest in air conditioners or color television. Sometimes, changes in the terms and availability of consumer instalment credit play a role. And a variation of even a half percentage point in the consumption-income ratio currently means a $2 billion change in consumer buying.

Ordinarily, however, variations of disposable income are the major cause of changes in consumption. But consumers typically do not adjust their spending at once to higher levels of disposable income. If disposable income increases in one quarter, the resulting increase in consumer spending usually spreads out into several succeeding quarters.

This pattern of consumer behavior has been evident in the present expansion. Although disposable income increased rapidly through the second quarter of 1962, consumers did not react fully and immediately, and the saving rate thus rose. In the rest of 1962, disposable income grew less rapidly, but the delayed effects of the rapid increases in disposable income during 1961 (combined with consumers' apparently favorable response to the new automobile models) led to continued good increases in consumption expenditures. The saving rate declined, reaching 6.6 percent in the first quarter of 1963.

Thus it was largely the temporary decline in the saving rate during 1962 that underwrote the expansion between mid-1962 and mid-1963. As Table 2 shows, nonconsumption expenditures increased between 1962 and 1963 by only $9.5 billion, compared with a gain of $18.0 billion from 1961 to 1962. But consumer spending, still under the impetus of the earlier income rise, moved up with little loss of momentum. At the end of 1963, the saving rate again moved upward as growth of disposable income accelerated. At this point, the tax cut of 1964 became a major influence on consumer spending.

## INVESTMENT AND CAPACITY UTILIZATION

Business fixed investment—including expenditures on new plants, machines, and equipment—rose strongly from 1961 to 1962, moved more sluggishly between 1962 and 1963, then rose vigorously in 1964. Over the whole expansion, from the first quarter of 1961 to the fourth quarter of 1964, the increase averaged 8 percent a year and accounted for 26 percent of the increase in total nonconsumption expenditures.

The average rate of utilization of manufacturing capacity was about 78 percent in the first quarter of 1961, 14 percentage points below the average rate of 92 percent preferred by managements. By the second quarter of 1962, the rapid gains in manufacturing output had raised the utilization rate to about 86 percent. Thereafter, slower gains in output were roughly matched by increases in capacity. Investment rose gradually, in part responding to the incentives provided by the 1962 tax measure. But capital outlays were relatively low and were presumably not primarily directed toward an expansion in capacity. The utilization rate was still 86 percent in late 1963. Beginning at the end of 1963, the promise—and then the fact—of accelerating gains in output brought a substantial stepping up of investment. By the third quarter of 1964 the average utilization rate had moved up to 88 percent, and investment in manufacturing had risen 18 percent over that of a year earlier.

Investment expenditures thus accelerated in response to a growth in demand for final products, gradually rising operating rates, improving rates of profit and cash flow (augmented by the new depreciation guidelines, the investment tax credit, and the reduction in tax rates), the continued ready availability of credit at relatively stable rates of interest, and a realistic and justified confidence in the continued strength of the economy.

Moreover, the machinery and construction industries generally have had little difficulty in satisfying the growing stream of orders for capital goods. This contrasts sharply with conditions in 1955–57, when capital goods industries lacked adequate capacity to meet demand (Table 3). In 1955 when the expansion of fixed investment began, the surge of new orders quickly exceeded the capabilities of the machinery and other capital goods industries. Capacity was soon strained, and unfilled orders climbed rapidly. Inflationary pressures developed in the capital goods industries and spread elsewhere, interacting with large wage increases throughout industry to raise costs and prices.

Investment expenditures in 1956–57 added to capacity throughout the private economy at a substantial rate. It is not clear whether that rate of

TABLE 3.—*Expenditures for manufacturing plant and equipment, and related data, 1955–57 and 1961–64*

[Based on seasonally adjusted data]

| Period | Expenditures for manufacturing plant and equipment (percentage change per year during period) | Manufacturing utilization rate (percent) [1] | | Backlog of unfilled orders for machinery and equipment (months) [2] | |
|---|---|---|---|---|---|
| | | Beginning of period | End of period | Beginning of period | End of period |
| 1955 I [3]–1955 IV | 32 | 87 | 92 | 3.70 | 4.32 |
| 1955 IV–1956 III | 37 | 92 | 87 | 4.32 | 4.62 |
| 1956 III–1957 III | 3 | 87 | 86 | 4.62 | 4.31 |
| 1961 II [3]–1962 II | 7 | 81 | 86 | 3.43 | 3.22 |
| 1962 II–1963 IV | 9 | 86 | 86 | 3.22 | 3.33 |
| 1963 IV–1964 IV [4] | 20 | 86 | 87 | 3.33 | [5] 3.58 |

[1] Output as percent of capacity. See Appendix Table B-35, footnote 1, for source.
[2] Ratio of unfilled orders to shipments.
[3] Trough quarter of manufacturing plant and equipment expenditures used.
[4] Preliminary.
[5] Based on October-November averages.

Sources: Department of Commerce and Securities and Exchange Commission (except as noted).

growth of capacity could have been maintained in all industries had total demands kept pace with the economy's potential. But in fact, demand weakened outside the capital goods sector, partly because of restrictive monetary and fiscal policy actions taken to stem price increases. Over-all operating rates fell sharply during 1956, while the investment boom continued. With the growth of final demand falling far short of the growth of capacity, the incentives for investment ultimately waned and the economy moved into recession in 1957.

In 1961–64, by contrast, utilization rates expanded both more slowly and more evenly as among industries. Investment responded more moderately, and the backlog of machinery orders consequently remained relatively low and stable.

## INVENTORIES

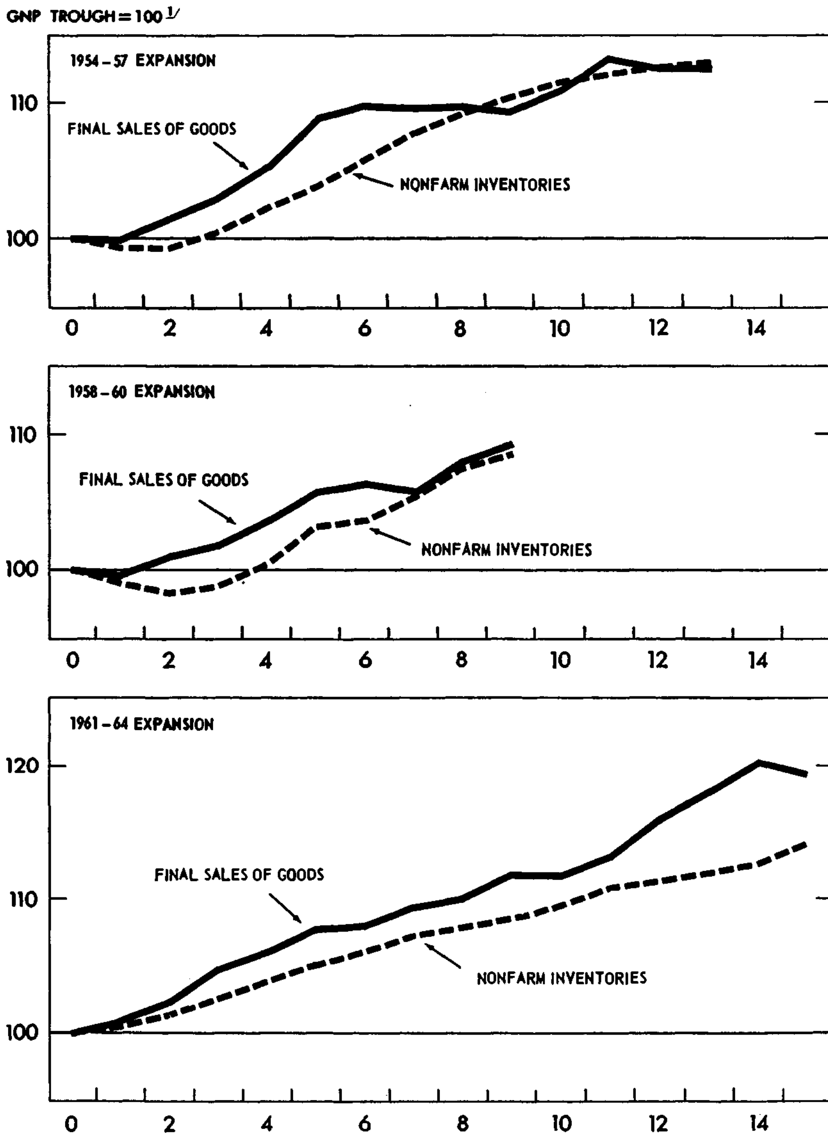
Inventory investment has contributed significantly to the balance and duration of the current expansion. Although it is usually one of the most volatile components of GNP, aggravating rather than smoothing swings in output and employment, inventory accumulation during the past fifteen quarters fluctuated more moderately and its movements were less perverse in timing than in other postwar expansions.

The relative steadiness and moderation of inventory investment are shown in Chart 3, which compares movements of nonfarm inventories and of final sales of goods in the three expansions since the Korean war. (Final sales of goods are total GNP less inventory accumulation and the production of services.)

During the past fifteen quarters, the percentage growth of inventories typically fell short of the growth of final sales. In other words, over this

Chart 3

# Inventories and Final Sales of Goods In Three Postwar Expansions




1/ BASED ON SEASONALLY ADJUSTED DATA IN 1954 PRICES; INVENTORIES AT END OF QUARTER AND TOTAL SALES FOR QUARTER. TROUGH QUARTERS FOR GNP WERE 1954 II, 1958 I, AND 1961 I.

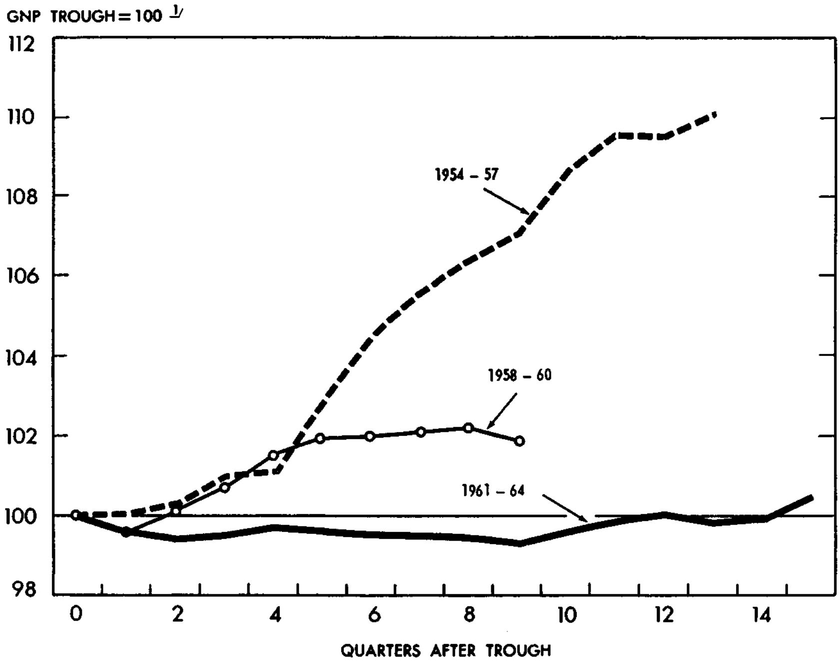
SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

period the ratio of inventories to sales declined. In each of the two preceding expansions inventories declined at first, then rose at roughly the same rate as sales until about the sixth quarter of expansion; thereafter, they continued to rise even after the trend in sales appeared to warrant little further inventory accumulation. These mounting imbalances between inventories and sales meant higher costs and risks of inventory holding, and set the stage for a liquidation of inventories when final sales turned down.

There are several reasons for the favorable relation between inventories and sales in the present expansion. First, final sales have moved ahead fairly steadily throughout the period. Second, forces which might motivate an expansion of inventories beyond the immediate needs of businesses have been minimal. Inflationary fears have been absent and, as a result, there has been little speculative inventory buying. Chart 4 shows the stability of wholesale industrial prices in recent years, contrasting sharply with the rises in 1955–56. Since capacity has been ample in relation to the volume of orders, businessmen have been assured of prompt deliveries, and normally have had little reason to hoard inventories. The short and stable lead-times

**Chart 4**

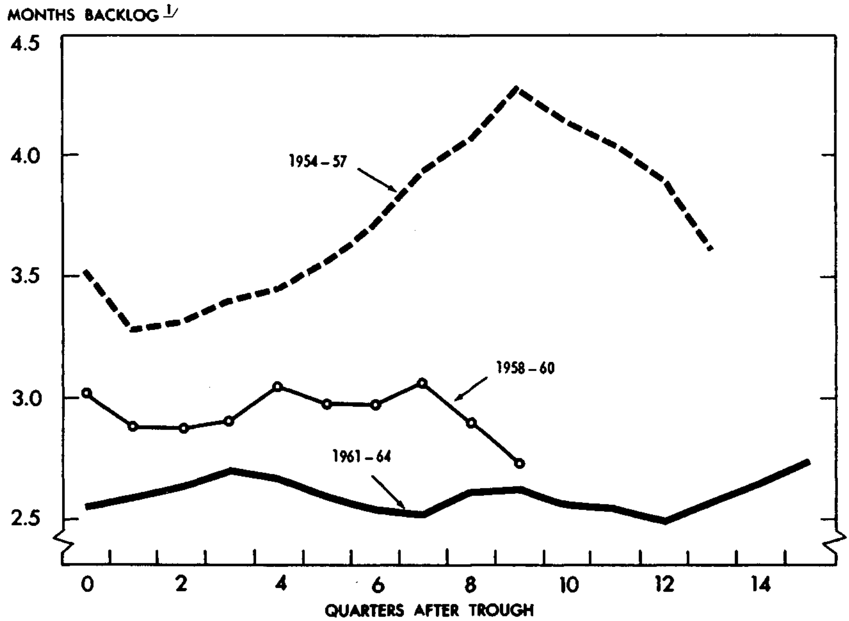
## Wholesale Prices of Industrial Commodities In Three Postwar Expansions




1/ TROUGH QUARTERS FOR GNP WERE 1954 II, 1958 I, AND 1961 I.
SOURCES: DEPARTMENT OF LABOR AND COUNCIL OF ECONOMIC ADVISERS.

Chart 5

## Unfilled Orders For Durable Goods in Three Postwar Expansions




1/ BASED ON SEASONALLY ADJUSTED MONTHLY AVERAGES. RATIO OF UNFILLED ORDERS TO PEAK SHIPMENTS TO DATE. TROUGH QUARTERS FOR GNP WERE 1954 II, 1958 I, AND 1961 I.

SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

between orders and shipments of durable-goods industries as a group in the current expansion are in contrast to the longer and more variable lead-times in the two preceding expansions (Chart 5). Third, the effects of improved methods of inventory control, including especially the use of computers, may now be sufficiently widespread to influence the behavior of inventories.

Additions to inventories were extraordinarily modest in 1964. As shown by Chart 3, sales maintained a very rapid pace, while—until the fourth quarter—inventory accumulation proceeded at the slowest rate since the beginning of the expansion. Reductions in inventory-sales ratios were general. Although lead-times lengthened somewhat, as shown in Chart 5, businessmen were apparently achieving desired inventory levels with a modest rate of inventory investment.

### RESIDENTIAL CONSTRUCTION

Expenditures for new private nonfarm residential construction climbed rapidly for six quarters from the first quarter of 1961; they then rose steadily, though more slowly, to a peak in the first quarter of 1964. During the rest of 1964 they tapered off. In each of the two preceding expansions, residential construction had grown even more rapidly at first; then, after only four or five quarters of expansion, it had begun a fairly steady decline.

Throughout the current expansion, funds for mortgage investment have been readily available at stable or declining rates of interest. This record diverges substantially from that of the two preceding expansions, when a scarcity of mortgage funds and sharply higher mortgage rates contributed materially to the premature decline of residential construction.

Practically the entire rise in residential construction during 1961–63 was in multi-unit starts and mostly in structures with 5 or more units. The proportion of multi-unit to total housing starts rose from 24 percent in 1958 to 36 percent in 1964. Single-family starts rose very slightly from early 1961 into 1962; since then they have decreased gradually, but fairly steadily, to, or perhaps below, the number in the first quarter of 1961. Multi-unit starts, by contrast, rose strongly from mid-1960 to late 1963; during 1964 they, too, declined.

Demand for apartments has risen with the increasing number of couples who, with children grown and away from home, find suburban houses inconvenient. Also, the number of young couples not yet ready for single-family houses is beginning to increase. Heavy apartment-building has occurred both in cities and in suburbs, the location determined in some cases by urban renewal, and always by land costs and degrees of traffic congestion. Particularly favorable provisions of the tax laws and innovations in financing and management techniques also have had an important influence on apartment-building in recent years.

During the four years 1961–64, housing starts totaled about 6 million, an excess of about 3 million over the net gain in households, or an average excess of more than 700,000 units a year. This excess is the highest four-year average in the postwar period.

The net addition to the stock of housing is, of course, usually smaller than the number of new units built. During the decade of the 1950's, demolitions and conversions accounted for an average decline of 300,000 units a year. The recent extensive activity in road-building and clearance for urban renewal and for private commercial and apartment-building in cities suggests that losses from demolition are now substantially larger than in the 1950's.

Nevertheless, it is probable that in recent years the net housing stock has grown more rapidly than the number of households, creating a considerable volume of vacancies and abandonments. However, there is no evidence that any serious surplus has occurred in the types of housing units or the areas where most new building occurs. To be sure, vacancies have reached unduly high levels in certain local markets; foreclosures and mortgage delinquencies have been high in a few areas; and substantial concessions have had to be granted on the terms of mortgages on some new apartment houses that have not rented well. In several local markets the absorptive capacity for high-rent units has been reached, at least temporarily, and lenders are more cautious about making financing commitments. Over the Nation as a whole, however, vacancy rates, delinquencies, and foreclosures have remained relatively low and stable.

The slowdown in new construction has come at a time when the general economy is expanding vigorously. This means that readjustments to correct possible local imbalances will not be aggravated by falling incomes and reduced over-all demand for housing. A vigorously expanding economy is able both to absorb and to facilitate temporary readjustments in particular sectors.

## INCOME SHARES

The division of income between labor and capital has undergone little or no change in the past decade, other than changes associated with fluctuations in the level of business activity. Recent experience continues that pattern.

To determine whether wages are growing at the expense of profits, or vice versa, analysis has to be confined to the private business sector of the economy, and—for lack of data—to the corporate sector. Changes in this sector, in any case, dominate movements in the whole economy. After subtracting corporate indirect taxes, the entire corporate gross product can be divided between employee compensation and the gross return to capital: profits before taxes, interest, and capital consumption allowances.

The shares of labor and capital in total corporate gross product (after indirect taxes) have displayed a stable pattern since 1954. By and large, the capital share moves closely with the utilization of capacity (Chart 6); correspondingly, the labor share moves opposite to capacity utilization.

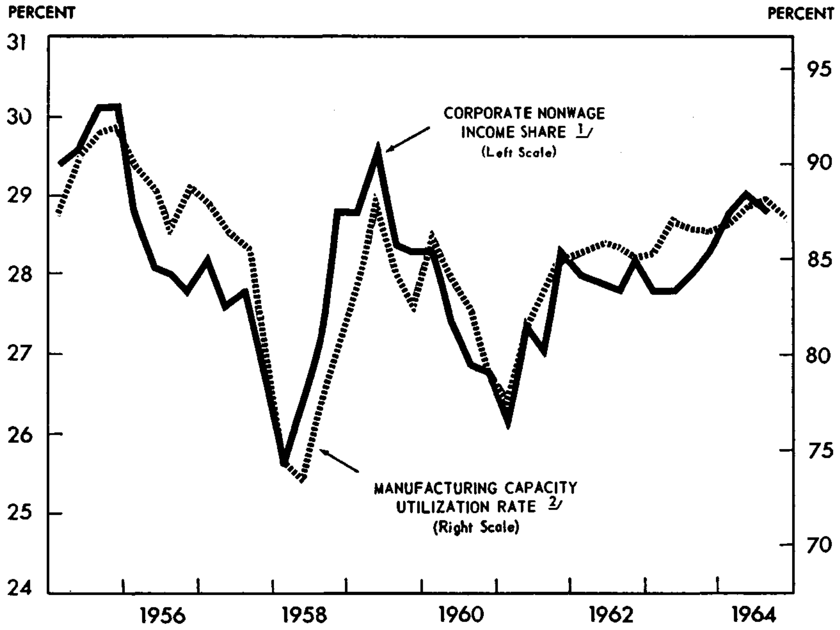
When utilization is low, firms carry excess overhead labor and run production processes at less than optimal rates. As a result, cost per unit of output rises, and the return to capital falls. Likewise, when production and the utilization of capacity increase, cost per unit of output falls and the return to capital rises. Since 1955, the relative share of labor in corporate gross product has ranged between a high of 74.4 percent in the first quarter of 1958 and a low of 69.9 percent in the second half of 1955, and has been free of any discernible trend, once adjustment is made for differing degrees of utilization.

The share of capital in gross corporate product rose to 29.0 percent in the second quarter of 1964, but it remained below peak proportions attained in 1955 and 1959. The capital share can be expected to continue to rise slightly as the economy moves toward full potential production, but this will not indicate a trend to a higher share for capital at full utilization of capacity than was the case earlier.

In the early part of each of the two previous expansions since the Korean conflict, the absolute magnitude of net corporate profits, before and after taxes, grew extremely fast (faster than the total return to corporate capital).

Chart 6

## Income Shares and Capacity Utilization




1/ CORPORATE PROFITS BEFORE TAXES (INCLUDING INVENTORY VALUATION ADJUSTMENT), CAPITAL CONSUMPTION ALLOWANCES, AND INTEREST AS PERCENT OF CORPORATE GROSS PRODUCT LESS INDIRECT TAXES.

2/ OUTPUT AS PERCENT OF CAPACITY.

SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS. SEE TABLE B-35 FOR SOURCE OF MANUFACTURING CAPACITY UTILIZATION RATE.

During the remainder of each expansion, profits steadily declined—both in absolute amount and as a share of income. In the current expansion, the gains of corporate profits were slower, but they were sustained without significant interruption, reflecting the fact that utilization rates moved upward more steadily. This, clearly, has contributed to the continuing expansion of investment.

Corporate profits before taxes were 9.5 percent of the total national income in the first quarter of 1961, held around 10.6 percent from the first quarter of 1962 through the third quarter of 1963, and averaged 11.3 percent of national income in the first three quarters of 1964. (Preliminary evidence suggests that profits dipped in the fourth quarter, primarily because of the automobile strikes.) As a result of changes in corporate tax rates, the share of corporate profits after tax rose a little faster—from 4.7 percent of total national income in the first quarter of 1961 to 6.2 percent in the third quarter of 1964.

Total employee compensation (including that from unincorporated businesses, governments, and institutions) rose from $294 billion in the first quarter of 1961 to $371 billion in the third quarter of 1964, or by 26 percent; but as a share of total national income, it remained close to 71 percent through the whole period. After taxes, however, total employee compensation has actually risen as a share of national income since the fourth quarter of 1963.

## CREDIT

### *Availability of credit*

A sustained growth of credit has helped to maintain the over-all advance in spending. Total new funds raised by individuals, businesses, and State and local governments have advanced relatively steadily, by close to 20 percent a year, since the first quarter of 1961. During each of the two preceding expansions, borrowing rose sharply during the first five or six quarters—at an average annual rate of about 50 percent in the first period and 90 percent in the second—and then declined during the remainder of the expansion. Thus the increase of credit in the current business upswing is less notable for its rate of growth than for its persistence.

The prolonged advance in residential construction activity reflected, in part, an easing of mortgage credit terms. The total volume of mortgage credit outstanding accounts for about 40 percent of the total outstanding debt of the nonfinancial sectors of the economy. It has risen at an average annual rate of more than 10½ percent since the end of 1960 (as shown in Table 4). This is faster than private debt in any other category.

A major factor in this ready availability of mortgage credit has been the rapid growth of consumer and business time and savings deposits, in response to the higher rates of return paid since early 1962 by commercial

TABLE 4.—*Expansion of selected types of credit in three postwar expansions*

| Period | Percentage changes in credit outstanding [1] | | | |
|---|---|---|---|---|
| | Bank loans to business [2] | Corporate bonds [3] | Mortgages | Consumer credit |
| 1954–57 expansion: | | | | |
| 1954 | −0.6 | 7.3 | 12.2 | 3.4 |
| 1955 | 16.2 | 5.6 | 14.3 | 19.6 |
| 1956 | 18.3 | 6.9 | 11.2 | 9.0 |
| 1957 | 4.0 | 11.0 | 8.4 | 6.2 |
| 1958–60 expansion: | | | | |
| 1958 | 1.6 | 8.9 | 9.7 | .4 |
| 1959 | 12.2 | 4.3 | 11.1 | 14.2 |
| 1960 | 5.8 | 4.8 | 8.4 | 8.7 |
| Current expansion: | | | | |
| 1961 | 3.4 | 6.0 | 9.4 | 2.9 |
| 1962 | 9.0 | 5.8 | 11.2 | 9.5 |
| 1963 | 10.1 | 4.3 | 11.7 | 10.7 |
| 1964 | 8.9 | 4.3 | 10.7 | 10.0 |

[1] Based on flow-of-funds accounts.
[2] Bank loans to nonfinancial business.
[3] Corporate bonds valued at par.

Source: Board of Governors of the Federal Reserve System.

banks (following successive increases in the permissible ceiling rates). A large proportion of these funds has been channeled into the mortgage market. At the same time, the continued substantial flow of funds to savings institutions other than commercial banks which, by law and custom, invest a large part of their funds in the mortgage market has also been important.

A second factor contributing to the ease of all long-term credit markets has been the moderate nature of the expansion in demands from business for external financing. With cash flow exceeding fixed investment outlays, as indicated in Table 5, and accumulation of inventories moderate, business firms have "financed themselves" to a greater degree than previously. Consequently, the volume of corporate bonds outstanding has expanded less rapidly, on the average, during recent years than during the preceding two expansion periods; and the amount of bank loans outstanding to business has expanded only slightly faster, despite the greater strength of the current expansion. Meanwhile, the cost of business borrowing at banks has been virtually unchanged, and interest costs on newly issued corporate bonds have fluctuated within a narrow range.

With relatively moderate demands for credit from business customers, financial institutions have had more funds available for mortgages, State and local government securities (at interest rates well below the last expansion period), and consumer credit. Outstanding consumer credit has grown at an average rate of about 8 percent a year. This growth roughly matches the average rate since 1953 but, as shown in Table 4, without the sharp fluctuations of the earlier periods.

In the first three years of the current expansion period, growth in bank credit outstanding accounted for about 30 percent of total new funds raised

TABLE 5.—*Sources and uses of corporate funds in three postwar expansions*

| End of period | Internal funds (billions of dollars) | Uses as percent of internal funds | | |
|---|---|---|---|---|
| | | Plant and equipment | Inventories | Increase in financial assets |
| 1954–57 Expansion: | | | | |
| 1954 | 19.8 | 113.1 | (1) | 15.2 |
| 1955 | 26.6 | 91.0 | 25.2 | 74.1 |
| 1956 | 27.8 | 107.6 | 27.3 | 27.0 |
| 1957 | 28.0 | 116.8 | 7.5 | 19.6 |
| 1958–60 Expansion: | | | | |
| 1958 | 26.0 | 101.5 | (1) | 43.5 |
| 1959 | 31.1 | 89.1 | 21.2 | 57.6 |
| 1960 | 29.1 | 105.8 | 8.6 | 36.1 |
| Current Expansion: | | | | |
| 1961 | 29.7 | 99.7 | 4.4 | 59.9 |
| 1962 | 35.2 | 90.9 | 12.5 | 51.1 |
| 1963 | 36.8 | 91.8 | 10.1 | 56.5 |
| 1964 | 40.9 | 95.8 | 7.8 | 51.1 |

[1] Inventories declined.

NOTE.—See Appendix Table B–68 for data used in computing percents shown in this table.

Source: Department of Commerce.

(including Federal Government borrowing). In 1964, the proportion probably fell somewhat as monetary policy became slightly less easy. Nevertheless, these are unusually high proportions for an expansion, partly reflecting the larger proportion of consumer savings placed in commercial banks and the active competition of banks for funds through the device of time certificates of deposit.

*Volume of debt and liquidity*

In the course of four years of relatively expansionary monetary policy, the total outstanding debt of the nonfinancial sectors of the economy (excluding the Federal Government) has risen at an average annual rate of 8½ percent, compared with a 5½ percent rate of increase in GNP. Aggregate consumer debt, including home mortgages as well as instalment and other types of household credit, has experienced particularly rapid growth. In appraising this growth, it is important to bear in mind that the outstanding amounts of home mortgages and instalment credit were abnormally low at the end of World War II. Since then, family use of credit has become a much more commonly accepted and widespread phenomenon, linked especially to widening home ownership. Thus, it would be perfectly normal to expect a steady rise in the ratio of the *outstanding debt* to income. Nevertheless, the ratio of the *net increase* in such debt—i.e., net new borrowing—to income has been relatively stable. As long as there is no persistent tendency for the ratio of new borrowing to income to rise, it is a matter of arithmetic that, although the ratio of outstanding debt to income will rise with steady growth of income, the rise would taper off and eventually cease, as the stock of outstanding debt approaches its new normal relationship to current income.

Furthermore, the increase of debt has a counterpart in the growth of assets held by individuals and businesses, much of it in liquid forms, such as bank deposits and share accounts. Consumers in particular increased their holdings of liquid assets rather abruptly during 1962 and 1963, and the ratio of their liquid assets to income is now well above the levels prevailing during the latter part of the 1950's. As interest rates on time and savings deposits rose relative to those on securities, consumers responded by changing the composition of their assets into these more liquid and now higher yielding forms. Business holdings of liquid assets have also increased, but proportionately less than business sales.

*Quality of credit*

In a prolonged period of healthy expansion and relatively plentiful credit, the tendency of financial institutions to confine credit extension to their traditional customers is reduced. This is clearly desirable so long as resources remain available and it does not lead to a large number of loan defaults, soaring prices of earning assets, or unsustainable burdens of debt relative to income.

In the current expansion, the ratio of net extensions of instalment credit to disposable income has remained below the peak ratios in 1955, 1959, and 1960, despite a temporary rise from early 1962 to mid-1963. Furthermore, data from consumer surveys suggest that, although a growing proportion of households is using credit, the typical ratio of debt to income has not risen. Meanwhile, the growth of liquid assets has increased the creditworthiness of many households.

The quality of mortgage credit is more difficult to evaluate because its characteristics differ widely from one geographic area to another. Although defaults and real estate foreclosures have risen somewhat, they remain quite low, and much of the increase is concentrated in a few localities. Mortgage delinquency rates have recently shown little change.

The soundness of the credit structure depends fundamentally on continued gains in income and on the liquidity and diversification of the portfolios of lending institutions. The latter must be primarily the responsibility of the institutions concerned, but supervisory authorities also have an important role in helping to prevent deterioration in the quality of credit.

## WAGES, PRICES, AND PRODUCTIVITY

Sustained economic expansion during the past four years was accompanied by a healthy balance among wages, prices, and productivity. Wholesale prices in 1964 averaged no higher than in 1960; consumer prices rose 1.2 percent a year; the growth in productivity was fairly steady, averaging 3.5 percent annually for the private economy; and wage gains kept up with, but did not outdistance, the trend in productivity. As a result, unit labor costs showed no general increase over the four-year period; income shares were free of distortions arising from inflation; and restrictive policies to curb an inflationary spiral were unnecessary.

The period was, essentially, inflation free. The small increases in the consumer price index and in the over-all "implicit deflator" for GNP must be interpreted in the light of the conceptual limitations of these measures.

None of our price indexes can reflect all of the improvement that occurs in the quality of goods, nor can an index make allowance for the rise in the value of the dollar that comes from the development of new products.

Further, the GNP deflator must include "prices" for the Government sector, even though there is no objective measure of public output. The "price" series for the public sector really measures the costs of inputs and cannot reflect the increase that occurs in productivity in Government. To a smaller extent this is also true for most of construction and some services.

Although the effects of these factors on our price indexes cannot be measured, their direction is clear. Their presence makes it doubtful that the actual purchasing power of the dollar changed perceptibly in the period 1961–64.

*Over-all record*

The rise in straight-time average hourly earnings in manufacturing during 1964 was about 3.0 percent, compared with 2.6 percent a year for the entire period 1960–64. Fringe benefits, of course, are not included. Whenever such benefits rise faster than wage rates, hourly earnings data understate the percentage rise in total average hourly compensation. Since 1960, total compensation per man-hour (including fringe benefits) has increased about 3.3 percent a year in manufacturing and 3.6 percent in the private economy as a whole. In 1964, the increases were 3.0 percent and 3.8 percent, respectively.

A special study of key labor agreements that were concluded during 1964 in 11 major industries showed a median increase in hourly compensation of 3.5 percent a year over the life of the contracts; most of these increases fell within a range of 2 percent to 5 percent.

The character of this expansion helps to explain this good wage-price-productivity record. As noted before, the expansion of demand has not overtaxed the economy's capabilities to produce. Balanced growth of output among sectors has prevented pressures for price and wage increases that might have resulted had there been capacity bottlenecks or shortages of manpower in particular industries. Price stability has made for prudent investment policies with respect to inventories and plant and equipment, and these policies in turn have reinforced the price stability.

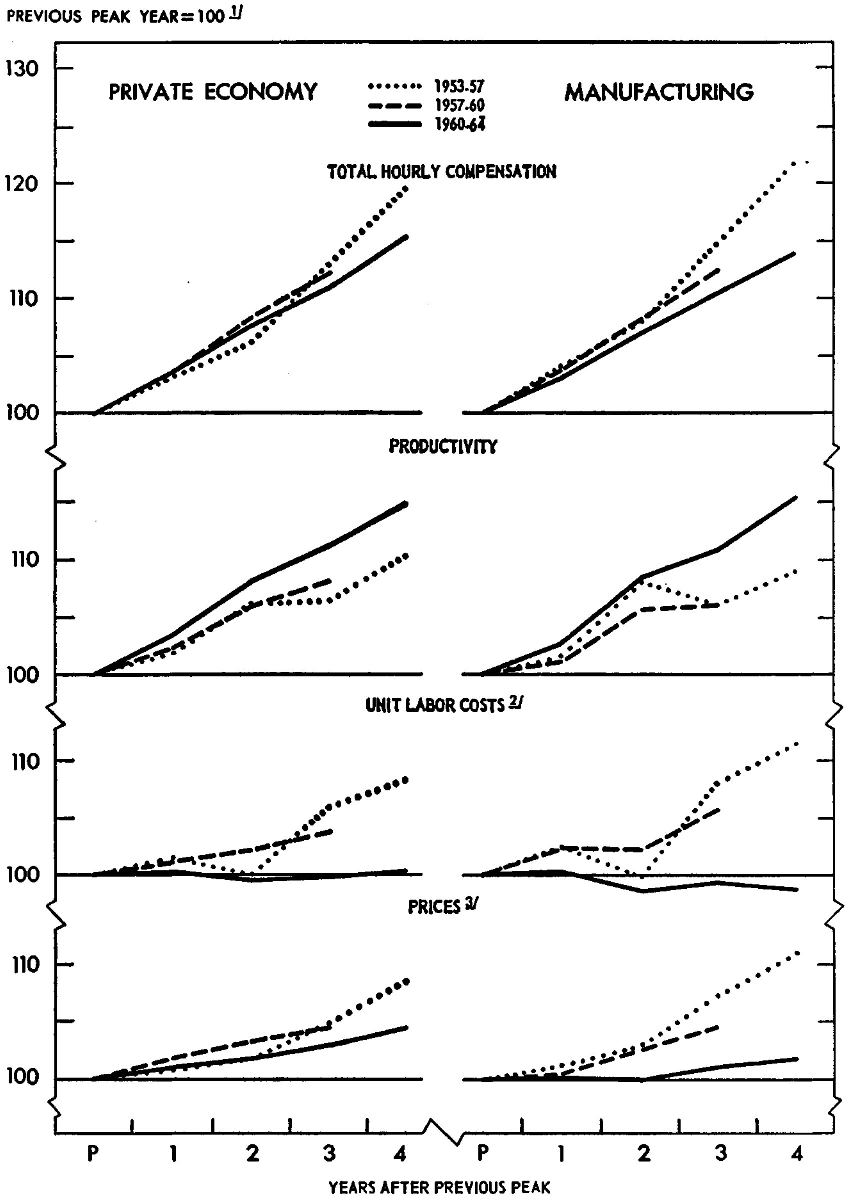
Where pressures for higher prices have occurred (particularly in primary metals), their source has ordinarily not been found either in excess domestic demand or in higher labor costs in our own economy. Sharp increases in prices of nonferrous metals in 1964 were caused largely by unsettled political conditions in supplying countries and by interruptions of production as a result of strikes. By the year's end, moreover, the prices of some metals had receded well below the peaks reached during the year.

*Comparison with previous expansions*

The course of wages, prices, productivity, and unit labor costs for both total manufacturing and the total private economy in the years since the prerecession year of 1960 is compared in Chart 7 with movements in the two "peak-to-peak" periods—1953–57 and 1957–60. The upward surge of wages, unit labor costs, and prices in the final two years of the 1953–57 period and the steady climb of costs and prices during 1957–60 are in clear contrast to the stability of the past four years. (In measuring price movements for the total private economy and for manufacturing, the "implicit deflators" prepared for calculations of "real" GNP were used. These deflators do not move identically with the wholesale price index, but they are consistent with the output and compensation data that are used.)

Chart 7

# Compensation, Productivity, Unit Labor Costs, and Prices in Three Postwar Periods




1/ PREVIOUS PEAK YEARS WERE 1953, 1957, AND 1960.

2/ RATIO OF TOTAL HOURLY COMPENSATION (FOR EMPLOYEE MAN-HOURS) TO PRODUCTIVITY (FOR ALL MAN-HOURS).

3/ IMPLICIT DEFLATORS FOR THE TOTAL PRIVATE AND MANUFACTURING SECTORS OF GROSS NATIONAL PRODUCT.

SOURCES: DEPARTMENT OF LABOR AND COUNCIL OF ECONOMIC ADVISERS.

The moderate gain of about 3.6 percent a year in hourly compensation in the total private sector during the present expansion compares with an advance averaging 3.9 percent a year in 1957–60 and 4.5 percent in 1953–57.

The rise in output per man-hour from 1960 to 1964 was larger and more evenly sustained than in the previous two periods considered. Gains in output per man-hour in the private sector in 1960–64 averaged 3.5 percent a year, compared with 2.5 in 1953–57 and 2.7 in 1957–60.

Strong gains in output and productivity typically take place during the recovery from a recession; they stimulate investment and extra hiring by business in anticipation of further gains in output. After the recoveries of 1955 and 1958, expected gains were not realized, the advance of productivity was retarded, unit labor costs were increased, and profits were squeezed. Especially in 1955–57, this helped to upset the balance among costs, prices, and income shares, and aggravated the wage-price spiral.

The better record of productivity performance during the past four years is in large measure the result of a sustained expansion of output that has kept operating rates moving upward. Total private output rose at an average annual rate of 4.1 percent a year from 1960 to 1964, or about 1½ times the average rate of about 2.7 percent during the two earlier periods considered. The difference in manufacturing is even more striking, with output gains averaging 4.8 percent a year since 1960, compared with about 1¼ percent a year in the two earlier periods.

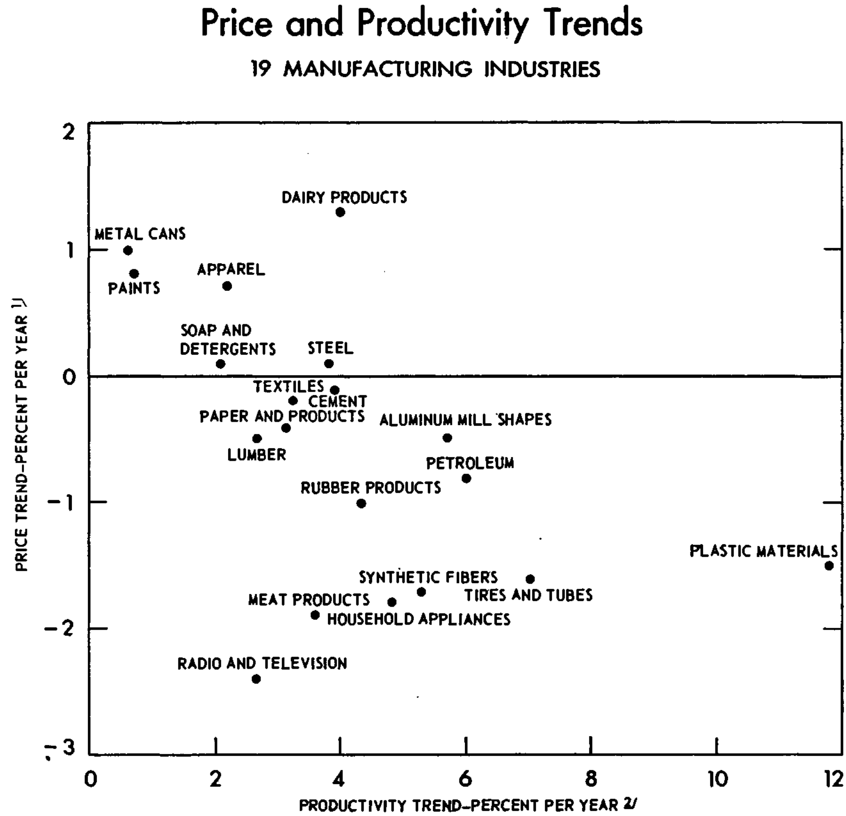
The steady gains in productivity and the moderate wage increases have held unit labor costs practically unchanged in the total private economy during the past four years and have resulted in a slight net reduction in manufacturing labor costs. Similarly, the implicit price deflators have risen very little, as Chart 7 makes clear.

### *Prices by industries*

Over-all price movements are the result of a continuous stream of price changes in individual industries—upward and downward. In industries where productivity rises slowly, unit labor costs tend to rise, while in industries where productivity rises more rapidly, unit labor costs tend to fall. During periods of expansion, industries with rising unit labor costs can easily pass them along in higher prices. But achievement of over-all price stability requires that savings resulting from faster than average increases in productivity be passed along in lower prices. Chart 8, which compares price and productivity trends for 19 manufacturing industries for which satisfactory physical output data are available, suggests that both developments have generally occurred during the current expansion.

However, in some instances, industries with large productivity gains made only token reductions in prices, or even raised them. Except where these movements reflect divergent movements in nonlabor costs, such cases give an upward bias to the over-all price level. Moreover, they tend to produce

Chart 8




1/ AVERAGE ANNUAL PERCENTAGE CHANGE IN WHOLESALE PRICE INDEX, 1959-64.
2/ AVERAGE ANNUAL PERCENTAGE CHANGE IN OUTPUT PER EMPLOYEE MAN-HOUR, 1959-64.
SOURCE: COUNCIL OF ECONOMIC ADVISERS (BASED ON DATA FROM DEPARTMENT OF LABOR AND BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM).

unusually high profits (as in the automobile industry) which serve as inviting targets for wage increases that exceed the general, economy-wide trend of productivity gains. If such wage increases were generalized, over-all price stability would be threatened.

Despite occasional exceptions—as in automobiles and construction—the general pattern of recent wage and price changes has closely approximated the Government's wage-price guideposts.

To be sure, the guideposts have not been completely effective either in stimulating all warranted price reductions, or in preventing some individual wage and price increases that are not in accord with their criteria. Nevertheless, the very fact that representatives of both labor and management have often explicitly indicated their compliance with, or tried to justify any deviations from, the guidepost standards suggests that these standards have had a useful influence.

In addition to any direct influence that they may have had on the wage and price policies of unions and managements, the guideposts have helped to create a new climate of opinion. Many groups in our society now have a better understanding of the relationships between costs and prices. There is increasing realization that it is appropriate—indeed necessary—to consider whether a proposed course of action, if followed by others in similar circumstances, would be consistent with over-all stability. Decision makers in unions and managements are increasingly aware both of the fact that their decisions affect the public interest and of the fact that the public is interested in their decisions.

## EMPLOYMENT AND UNEMPLOYMENT

In early 1961, the unemployment rate was close to 7 percent and it had continuously exceeded 5 percent during the three preceding years. New jobs were not being created fast enough to keep up with the expanding labor force.

From 1961 to 1962, the expansion of output was rapid, but gains in productivity also were high, as is typical after a recession. Nonetheless, employment increased by 1.2 million (Table 6). Because growth of the labor force

TABLE 6.—*Changes in employment, 1961–64*

| Type of change and period | Total [1] | Teenagers | Nonwhites | Adult whites |
|---|---|---|---|---|
| Change in employment (thousands of persons): | | | | |
| 1961–62 [2] | 1,203 | 237 | 159 | 813 |
| 1962–63 | 963 | −38 | 137 | 847 |
| 1963–64 | 1,548 | 268 | 246 | 1,075 |
| Percentage change in employment: | | | | |
| 1961–62 | 1.8 | 4.6 | 2.3 | 1.5 |
| 1962–63 | 1.4 | −.7 | 1.9 | 1.5 |
| 1963–64 | 2.2 | 5.1 | 3.4 | 1.9 |
| Percent of total employment change: | | | | |
| 1961–62 | 100.0 | 19.7 | 13.2 | 67.6 |
| 1962–63 | 100.0 | −3.9 | 14.2 | 88.0 |
| 1963–64 | 100.0 | 17.3 | 15.9 | 69.4 |

[1] Detail shown will not add to totals because of duplication (nonwhites include some teenagers).
[2] Data for 1962 are adjusted for comparability with data for 1961.

NOTE.—Teenagers include those 14–19 years of age; nonwhites, 14 years of age and over; and white adults 20 years and over.

Sources: Department of Labor and Council of Economic Advisers.

was relatively small, the over-all unemployment rate fell from 6.7 percent to 5.6 percent. From 1962 to 1963, employment increased by less than one million—enough to absorb the increase in the labor force but not enough to reduce the unemployment rate.

In 1964, the faster rate of economic expansion brought an increase of 1.5 million jobs. Since this was in excess of the increase in the labor force, the unemployment rate fell to 5.2 percent for the year as a whole (and to 5.0

percent by the end of the year). There was a net gain of 1.7 million nonagricultural jobs, but falling agricultural employment opportunities—continuing a long-term trend—offset 0.2 million of the increase.

*Employment among teenagers and Negroes*

Between 1962 and 1963, when employment rose only enough to offset the increase in the labor force, job gains were heavily concentrated among adult whites (20 years of age and older). Teenage employment actually declined, and increases for Negroes were limited.

The situation was different in 1964. There was a dramatic shift not only in the size but also in the character of the employment gains. Negroes and teenagers began to find jobs in larger numbers, and their percentage of the total increase in employment was considerably above that in 1963.

These data illustrate an unhappy fact: When the job market is slack and production grows only enough to create jobs for the normal increase in the labor force, adult whites secure the largest share of the new jobs, while unemployment among teenagers and Negroes is high and probably rising. (Similarly, during recessions, when the absolute number of jobs declines, Negroes and teenagers suffer the heaviest employment losses, and their unemployment rates rise much faster than those of adult whites.) As long as jobs are scarce and job applicants abundant, many employers give automatic preference to adult whites. Those without previous job experience and members of minority groups go to the end of the hiring line.

Growth of the teenage labor force in 1964 far exceeded any previous increase, but jobs for teenagers increased even more, and the over-all unemployment rate for this group—still far too high—fell only slightly. Better education and vocational preparation of teenagers, and reduced discrimination against minority groups, can significantly enlarge the employment opportunities open to any individual teenager or Negro. But adequate and permanent improvements in the high unemployment rates of these groups clearly require that recessions be avoided and that economic expansion be sufficiently rapid to keep over-all unemployment low.

*Unemployment in areas of chronic depression*

In 1960, 19 major labor market areas in the United States had substantial and persistent unemployment, with rates of 6 percent or higher, and an unemployment history much worse than the national average. From 1961 to 1963, unemployment in these areas declined from 10.3 percent to 6.4 percent, but a major part of the decline was due to a shrinking labor force. Some workers moved to other areas, and others simply withdrew from the labor force.

From 1963 to 1964, there was a further decline in unemployment, to 5.5 percent, but there was a significant change: the labor force in these areas reversed a five-year decline and started to increase. The labor force rose by 33,000 and employment increased by 62,000.

---

Although the 1964 record of gains in employment is heartening, the American economy still faces major employment problems:

(1) Five percent of the labor force, 3.7 million persons, remains unemployed.

(2) The increase in the civilian labor force, which has averaged about 1 million a year over the past four years, is expected to average 1½ million a year between 1964 and 1970.

(3) In 1965, the number of 18-year-olds will increase by almost 1 million; and growth of the teenage labor force will be approximately 500,000—double its growth in 1964.

(4) The unemployment rate for Negroes remains more than double that for whites.

(5) Unemployment is far too high in many local labor markets.

While full solution of these and related problems requires many kinds of policies, the maintenance of a high rate of growth in over-all demand is a necessary and crucial element.

## CONTRIBUTION OF FEDERAL FISCAL AND MONETARY POLICIES

Federal policies have made a major and continuing contribution to the great achievements of the American economy during the past four years. These policies were not laid down in one master plan early in 1961 and then carried out on a predetermined schedule. There have been delays, surprises, and a need to adapt policies to changing events; but policies have had a unified direction and strategy. They have consistently reflected a number of basic ideas shared by those responsible for Federal economic policies. These basic ideas include the following:

(1) A firm belief that the United States must make optimum use of the tremendous productive capacity of its economy; conversely, an abhorrence—for both human and economic reasons—of the waste of resources and opportunities involved in a prolonged underutilization of that capacity;

(2) A recognition that Federal purchases, taxes, and transfer payments are a major force, along with monetary policy, in determining the strength of the total market demand for productive resources;

(3) A full understanding of the key role of private investment in total market demand and in the long-term growth of incomes, and of the need for adequate profit incentives to stimulate this investment;

(4) A recognition that expanding consumption is necessary if increasing investment and over-all growth are to be maintained;

(5) A belief that vigorous efforts are necessary to restore equilibrium in the balance of payments;

(6) A determination to achieve reasonable price stability in order to preserve equity at home and to improve our international competitive position both at home and abroad,

(7) A conviction that, if they are to be effective, policies cannot respond passively to what has already transpired, but must try to foresee and shape future developments, remaining flexible and ready to change speed or direction yet holding to fixed goals;

(8) A belief that the American people share these ideas and are ready to support imaginative but carefully considered innovations in public policy.

These basic ideas have been applied during the past four years in a number of areas of economic policy. The following sections relate to their application in the fields of fiscal and monetary policy.

## FISCAL POLICY, 1961–64

The instruments of fiscal policy—purchases of goods and services, transfer payments, subsidies, grants-in-aid, and taxes—are the Government's most powerful tools for expanding or restraining over-all demand. Federal purchases of goods and services are directly part of market demand, and—through their impact on production, employment, and income—encourage further private consumption and investment expenditures. Taxes, transfers, subsidies, and grants-in-aid affect consumption and investment through their influence on disposable personal income, after-tax profits, incentives, and State and local expenditures.

The basic task of Federal fiscal policy is to help to provide a total market demand for goods and services that neither exceeds nor falls short of the economy's productive capacity at full employment. Maintaining this continuous balance between demand and capacity normally involves two basic requirements. First, since total productive capacity grows steadily over time, total demand also must grow. Second, since fluctuations in private demand occur independently of Federal policy, these fluctuations must be offset in order to avoid dips or surges that could touch off recession or inflation.

Since 1960, a third requirement has been added as the result of earlier failures to meet the first two: the need to eliminate the large gap that developed in the late 1950's between potential output and demand. Thus, in the last four years the main challenge to U.S. policy has been to stimulate a massive growth in total demand, sufficient not merely to *keep up* but to *catch up* with the growth of productive capacity. During the past four years, fiscal policy has been dominated by this purpose. In addition to a growth of $21 billion in Federal expenditures (first quarter 1961 to fourth quarter 1964), reductions in tax liabilities now in effect leave about $16 billion more a year in private hands than would be the case under 1960 tax rates.

As previous Annual Reports have shown, the stimulus provided by a given budget cannot be measured by the realized surplus or deficit. Since tax revenues and some expenditures automatically vary with economic activity, the realized surplus or deficit reflects the automatic effect of these variations, as well as discretionary actions on the part of the Federal Government. To distinguish the two effects, revenues and expenditures are calculated at a fixed level of economic activity—usually the full-employment level. At any given time, the larger the surplus at full employment, the more restrictive is fiscal policy; changes in the full-employment surplus or deficit indicate whether fiscal policy has, on balance, moved in an expansionary or a restrictive direction. This concept cannot measure perfectly the effect of a given budgetary change because it does not reflect changes in the composition of the budget. Moreover, a rise in the level of the budget may have a stimulating effect even with no change in the full-employment surplus. But the full-employment surplus is the best simple measure available and is a useful tool of analysis.

For the calendar year 1960, the Federal budget, on a national income and product account basis, showed an actual surplus of $3.5 billion, but the full-employment surplus was about $13 billion (Chart 9). Given the extent of the unutilized human and material resources, this surplus obviously needed to be reduced.

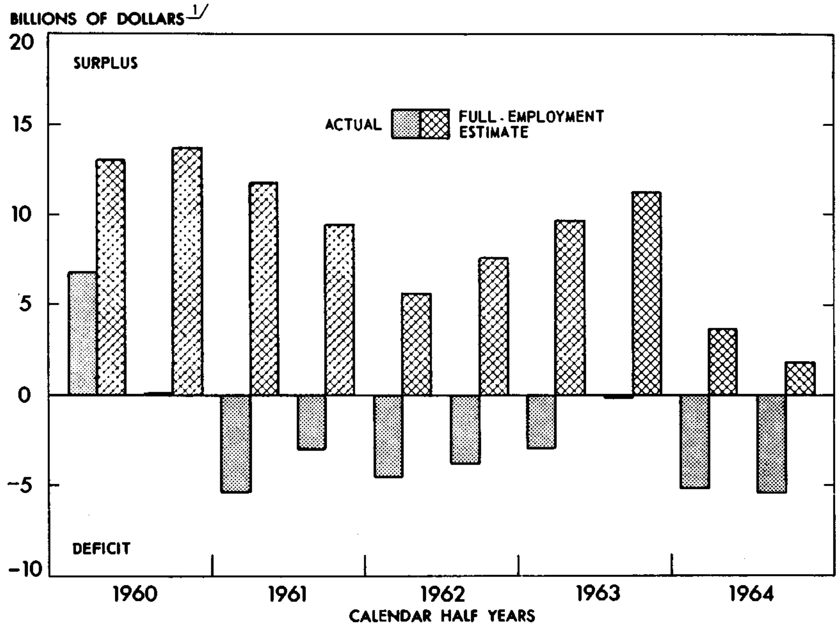
During 1961 a sharp increase in expenditures had an expansionary impact on the economy. As this increase was in excess of built-in gains in revenue at full employment, a first step was taken toward reducing the full-employment surplus. After the initial increase, the growth of expenditures continued at a substantial though slowing pace through the following two years. From the first quarter of 1961 to the fourth quarter of 1963, total Federal expenditures, which include transfer payments, subsidies, interest, and grants-in-aid, as well as purchases of goods and services, increased by $17 billion, or roughly 17 percent. These expenditures, undertaken primarily to strengthen defense and space programs but also to provide for unmet civilian needs, directly raised the level of aggregate demand and were highly stimulating to the rest of the economy.

The stimulus of fiscal policy was not limited to the expenditure side of the budget. Two tax-reducing measures were adopted to provide a needed long-run stimulus to lagging private investment. New depreciation guidelines were announced in July 1962, and an investment tax credit was enacted by Congress in the Revenue Act of 1962. The net effect of these two measures was to increase by $2½ billion the annual cash flow to corporations and to increase appreciably the after-tax rate of return on new investment projects, thus providing a needed long-range stimulus to investment. Through a combination of expenditure increases and tax reductions, the full-employment surplus was reduced to about $6½ billion in 1962.

Chart 9

## Federal Surplus or Deficit: Actual and Full-Employment Estimates

NATIONAL INCOME ACCOUNTS BASIS




1/ SEASONALLY ADJUSTED ANNUAL RATES.

SOURCES: DEPARTMENT OF COMMERCE, BUREAU OF THE BUDGET, AND COUNCIL OF ECONOMIC ADVISERS.

Although it had been hoped that these measures, together with an accommodating monetary policy, might stimulate sufficient recovery of private spending to bring total demand to full-employment levels, events proved otherwise. Unemployment fell to 5.6 percent by the beginning of 1962 but then held close to that unsatisfactory level. Major expansionary fiscal action was needed to strengthen and sustain the upswing.

Thus in August 1962, President Kennedy reported to the Nation that a major tax reduction would be proposed to accelerate the economy's progress toward full employment. This recommendation constituted a milestone in the use of fiscal policy to meet the requirements of the Employment Act, as well as a dramatic innovation in the choice of fiscal instruments.

However, Congressional action on the proposal was not completed in 1963. Since Federal expenditures were not rising as rapidly as in the two preceding years, the full-employment surplus began to rise again. Thus the Federal Government provided no further stimulus to the economy as full-employment revenues rose (because of the normal trend growth of full-employment GNP) more rapidly than expenditures.

By the fourth quarter of 1963, the full-employment surplus reached $11 billion, and even the realized budget, on a national income and product account basis showed a surplus. At the same time, output remained about $30 billion short of potential and the unemployment rate at 5.6 percent.

The aggregate demand generated by business, consumers, and governments had not been adequate to move the economy even close to full employment. The future course of the expansion was in doubt, and enactment of President Kennedy's tax cut recommendation had become increasingly urgent.

REVENUE ACT OF 1964 AND ITS EFFECTS

Under the vigorous leadership of President Johnson, the tax-reduction bill was enacted early in 1964. At 1964 levels of income, personal income tax liabilities were cut by $6.7 billion and corporate profits tax liabilities by $1.7 billion. With further reductions in rates taking effect in 1965, the cuts in liabilities will be $11 billion for individuals and $3 billion for corporations. Withholding rates on wages and salaries were reduced from 18 percent to 14 percent in one stage in early March 1964, rather than in two stages. This meant that most of the tax reduction was immediately reflected in consumers' disposable incomes.

The Council's 1964 Annual Report estimated that a personal tax cut of nearly $9 billion would result in a direct increase of more than $8 billion in consumption. Subsequent rounds of spending and respending would add another $10 billion to consumption—producing a tax cut "multiplier" of about two. Thus, through increased consumption alone, GNP would ultimately be raised by more than $18 billion above what it would have been in the absence of the tax cut.

The evidence to date indicates that this expectation is being borne out. After rising to 7.9 percent in the second quarter of 1964, the ratio of personal saving to disposable income had fallen back to a relatively normal 7.1 percent in the third quarter, suggesting that the gains of disposable income resulting from tax reduction were already being largely spent for the purchase of consumer goods and services. (A jump in the saving rate in the fourth quarter appears to be attributable to delayed deliveries of automobiles as a result of strikes.) The tax cut directly added $7.7 billion to disposable income in 1964, and the addition was running at an annual rate of $9½ billion by the end of the year. The Council estimates that the total increase in consumer spending alone resulting from the tax cut's impact was $9 billion in 1964, and had reached an annual rate of $13 billion by the end of the year. Subsequent rounds of spending and respending will bring the full impact on consumption in 1965 and beyond.

From 1963 to 1964, GNP grew 4.5 percent after adjustment for price changes. The above calculations suggest that, in the absence of the tax cut, the growth would have been only 3.0 percent, even if it is assumed that without the tax cut all expenditures other than consumption would have been just what they in fact were.

These figures, however, underestimate the full beneficial effects of the cut. Tax policies were also prominent among the factors that helped to generate a $5.0 billion advance (current prices) in business fixed investment between the fourth quarters of 1963 and 1964. The depreciation reform and the investment credit of 1962 continued to provide added strength to capital spending. The Revenue Act of 1964 reduced the basic rates of corporation taxes and, by increasing consumer demand, gave businessmen added assurance of sustained expansion and expanded markets. This assurance was a stimulating factor, even before tax cuts added to sales or cash flow. As the tax cut raised cash flows and operating rates during the year, business investment plans were revised upward.

Since the full effects on business investment of greater sales, improved profits, and larger cash flow are accomplished only after a substantial lag, and since part of the tax cut becomes effective in 1965, much of the rise in investment stimulated by the 1964 tax cut is still ahead of us. This extra investment will have multiplied effects on total production through the route of expanded incomes and larger consumer spending.

## MONETARY POLICY IN THE EXPANSION

Monetary policy operates by changing the availability and cost of credit to businesses, consumers, and governments. These changes are accomplished most directly by affecting the reserves available to commercial banks; but through its impact on bank policies and financial markets, monetary policy affects the general credit structure of the economy.

Monetary policy's impact on expenditures, and thus on employment, comes when businesses, consumers, or governments—finding borrowing (or liquidation of financial assets) easier or harder, less costly or more costly—are induced to spend more or less than they would otherwise have spent.

### *Tools and objectives*

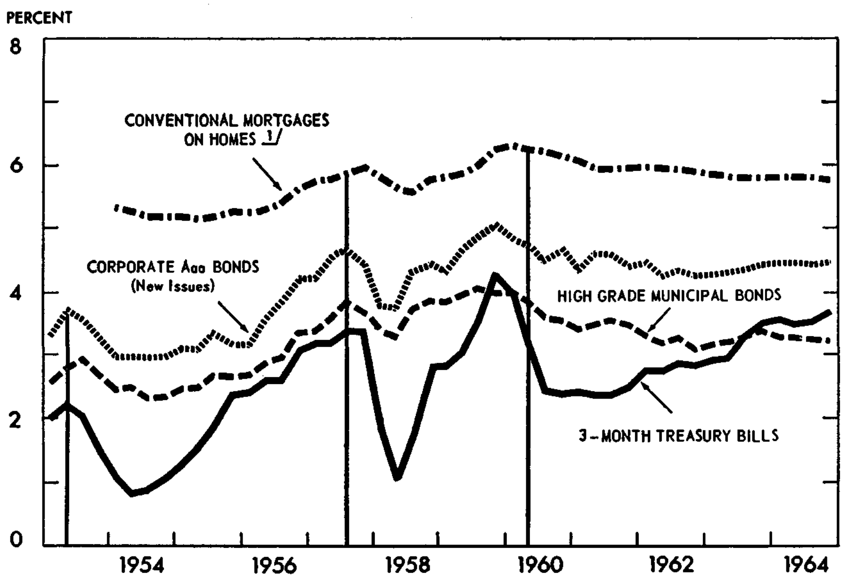
Throughout the current expansion, monetary policy has supported the objectives of fiscal policy by maintaining a ready availability of credit, thus accommodating an expansion of demand. It has pursued this objective while meeting the requirement to maintain an appropriate relationship between short-term interest rates in the United States and in other major money markets in order to dampen the outflow of volatile short-term funds. As many European countries have been using monetary policy to restrain demand, their central banks have maintained higher interest rates than would have been appropriate in the United States. Although U.S. short-term interest rates have been nudged upward to prevent an outflow of interest-sensitive funds seeking higher rewards abroad, policy has endeavored to avoid transmission of these pressures to the long-term market (more crucial for domestic investment) and to maintain a ready availability of credit relative to demand.

The success of this policy can be seen most clearly by comparing the pattern of yields that has emerged during the current expansion with that during previous upswings (Chart 10). During the recession of 1960–61, the Treasury bill rate was kept considerably higher than in either the 1954 or the 1958 recession. Subsequently, however, bill rates rose more gradually, and monetary policy remained—in many respects—significantly easier than in previous expansionary periods. However, the general level of interest rates is higher than at any period since the early 1930's.

One indication that credit conditions have remained relatively easy during the current expansion is the fact that commercial banks have consistently been kept in a positive net free reserve position, in sharp contrast to the expansions of 1954–57 and 1958–60 (Chart 11). As credit demand has strengthened, total bank reserves have been steadily increased by Federal Reserve operations to prevent the banking system as a whole from having to borrow heavily to meet the increase in required reserves. The annual growth in total reserves, adjusted for changes in reserve requirements, has

**Chart 10**

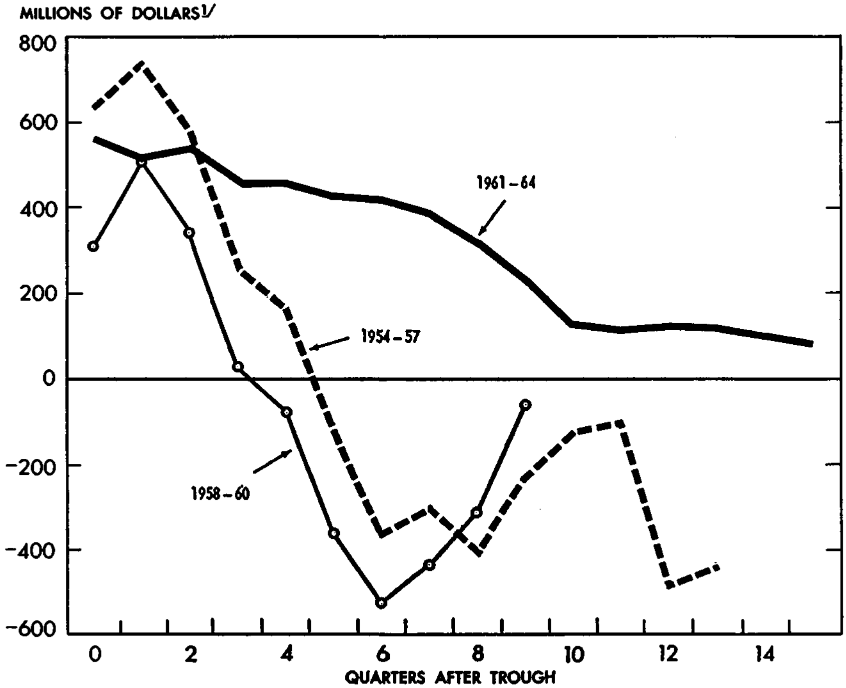
## Selected Interest Rates




1/ SERIES BEGINS IN 1954; NEW AND EXISTING HOMES THROUGH 1960 I, AND NEW HOMES ONLY THEREAFTER.
NOTE: VERTICAL LINES SHOW GNP PEAK QUARTERS; 1953 II, 1957 III, AND 1960 II.
SOURCES: FEDERAL HOUSING ADMINISTRATION (FHA), BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, MOODY'S INVESTORS SERVICE, AND STANDARD AND POOR'S CORPORATION.

Chart 11

## Free Reserves in Three Postwar Expansions




1/ AVERAGE OF DAILY FREE RESERVES OF MEMBER BANKS (EXCESS RESERVES LESS BORROWINGS).
TROUGH QUARTERS FOR GNP WERE 1954 II, 1958 I, AND 1961 I.
SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

averaged 3.6 percent since the end of 1960, in contrast to an average growth of 1.8 percent during the preceding seven years. The initial steps to maintain this expansion of reserves, while short-term rates were being raised, came when the Federal Reserve began providing reserves in part through open market operations in Treasury notes and bonds in early 1961.

Successive increases in maximum permissible interest rates on time and savings deposits in January 1962, July 1963, and November 1964 served the double purpose of permitting domestic banks to compete more effectively with foreign banks for deposits and of channeling private savings and business liquidity into time and savings deposits. These funds then flowed, in large part, into longer-term loans and securities, maintaining a downward pressure on longer-term yields. In the process, these higher ceiling rates also permitted commercial banks to compete more actively for domestic funds. This contributed to the growth of bank deposits relative to other forms of asset holding and of bank credit relative to other sources of lending.

The expansion in total bank credit has exceeded the growth of bank reserves, as time deposits—which now require a reserve backing of 4 percent—have risen relative to demand deposits, which require a backing of 12 to 16½ percent. Since the end of 1960, bank credit has risen at an average rate of 8 percent a year, thus increasing somewhat faster than the advance in GNP, in contrast to previous business upswings.

The need to raise short-term interest rates for balance of payments reasons prompted a series of shifts toward moderately less credit ease. These occurred in December 1961, June and December 1962, May–July 1963, and August 1964. In July 1963 and November 1964, the discount rate was increased as well. While short-term rates were raised, the steps taken to assure the availability of adequate credit helped to protect longer-term interest rates. As shown in Chart 10, longer-term yields fell little during the 1960 recession, but they have been steadily resistant to upward pressures during the expansion.

Debt management policies of the Treasury also have been directed toward supporting short-term interest rates. In each of the past four years, the volume of bills issued by the Treasury accounted for half or more of the total increase in the marketable debt. Meanwhile, the Treasury used advance refunding operations to counteract the tendency for the passage of time to shorten the maturity of the Federal debt.

*Policy in 1964*

In the past year, monetary policy continued to serve domestic expansion while helping to protect against outflows of short-term capital—its effectiveness reinforced by growing public understanding of its objectives. The basic guidelines of monetary policy remained essentially unchanged between July 1963 (when the discount rate was raised from 3 to 3½ percent to support other new balance of payments measures) and the late summer of 1964. At that time, the Federal Reserve moved to reduce reserves slightly in order to tighten further the reins on the outflow of dollars. On November 23, following the rise in the British bank rate, the Federal Reserve announced an increase in the discount rate to 4 percent as a precautionary move to forestall capital outflows. This was accompanied by a rise in the bill rate to about 3.8 percent.

Despite these moves to raise short-term interest rates for balance of payments purposes, yields on long-term securities remained remarkably stable during the year. There was a brief period of rising yields in March, reflecting uneasiness over possible sharp increases in demands for credit after the tax cut, and again in September and October over the implications of the British balance of payments problem. But in each instance, yields subsequently receded; at the year end, average yields on long-term Treasury bonds were within .02 percentage points of their low for the year.

Meanwhile, bank credit grew by 7.9 percent, almost exactly matching the expansion in 1963. The money supply, which had increased by 3.8 percent in 1963, grew by 4.0 percent in 1964, despite the sharper step-up in growth of GNP. The growth of money supply plus time and savings deposits of commercial banks was slower in 1964 than in the preceding year, when time and savings deposits grew more rapidly in response to the appreciable relative rise in interest rates paid on them, and when monetary policy was easier.

## APPROACHING EXTERNAL BALANCE

During the past four years, the external payments position of the United States improved. For most of 1964, the balance of payments deficit on regular transactions ran at an average annual rate of little more than half the $3.9 billion recorded in 1960 (Table 7). However, while the improvement was substantial and occurred during a period when the U.S. domestic economy enjoyed strong and sustained expansion, it is by no means enough. Moreover, it now appears that an unusual combination of factors resulted in a sizable rise in the deficit during the fourth quarter. Thus, the balance of payments continues to require serious attention.

When the Kennedy-Johnson Administration took office in early 1961, the United States had just experienced its third successive year of large payments deficits. Such deficits did not mean that the country was "living beyond its means" in terms of its use of resources or that the wealth position of the United States was impaired, for our exports of goods and services were substantially in excess of our imports and our total assets abroad were rising faster than our liabilities. The deficit did, however, represent a decline in net U.S. liquidity that could not be permitted to persist, particularly in view of the special role of the dollar as a major reserve currency. There were indications, moreover, that the underlying competitive position of U.S. export products had been deteriorating for a number of years, suggesting possible further increases in the payments deficit. And in late 1960, international currency markets had become unsettled as speculative outflows of short-term dollar funds increased and the price of gold on the London gold market rose sharply.

The need for action to improve the U.S. external balance was thus readily apparent. At the same time, however, doubts were being widely expressed that an improvement in the payments position would be feasible if the new Administration were to pursue its announced goal of renewing economic expansion. Indeed, the view was widely held that the rise in imports normally associated with economic expansion would necessarily worsen our international accounts.

This view was rejected by the Administration. Instead, policies were based on a fundamental conviction that sound growth of the domestic economy was compatible with longer-run improvement in the balance of payments. Only a strong, resilient, and dynamic economy, characterized by reasonable price stability, would permit the gains in productivity and provide the spur to innovation needed for an underlying improvement in our international competitive position. Moreover, a vigorous and dynamic U.S.

TABLE 7.—*United States balance of payments, 1960–64* [1]

[Billions of dollars]

| Line | Type of transaction | 1960 | 1961 | 1962 | 1963 | 1964: First 3 quarters |
|---|---|---|---|---|---|---|
| | *Regular transactions:* | | | | | *Seasonally adjusted annual rate* |
| 1 | Balance on goods and services | 3.9 | 5.6 | 5.1 | 5.7 | 8.1 |
| 2 | Balance on trade | 4.7 | 5.4 | 4.4 | 5.0 | 6.4 |
| 3 | Merchandise exports | 19.5 | 19.9 | 20.6 | 22.0 | 24.7 |
| 4 | Commercial exports of goods | 17.5 | 17.7 | 18.2 | 19.3 | 21.8 |
| 5 | Exports of goods financed by Government grants and capital | 1.9 | 2.2 | 2.4 | 2.7 | 2.8 |
| 6 | Merchandise imports | −14.7 | −14.5 | −16.1 | −17.0 | −18.3 |
| 7 | Balance on nonmilitary services | 1.8 | 2.7 | 3.0 | 2.9 | 3.8 |
| 8 | Investment income, net [2] | 2.3 | 3.0 | 3.3 | 3.3 | 4.0 |
| 9 | Other commercial services, net | −.8 | −.7 | −.8 | −.9 | −.8 |
| 10 | Service exports financed by Government grants and capital | .3 | .4 | .5 | .6 | .6 |
| 11 | Military expenditures, net [3] | −2.7 | −2.6 | −2.4 | −2.2 | −2.1 |
| 12 | Remittances and pensions | −.7 | −.7 | −.7 | −.8 | −.8 |
| 13 | Government grants and capital outflows | −3.4 | −4.1 | −4.3 | −4.5 | −4.2 |
| 14 | (Transactions involving no direct dollar outflows from the United States) | −2.3 | −2.9 | −3.2 | −3.6 | −3.5 |
| 15 | (Dollar payments to foreign countries and international institutions) | −1.1 | −1.1 | −1.1 | −.9 | −.7 |
| 16 | Scheduled repayments on U.S. Government loans plus changes in associated liabilities | .6 | .7 | .7 | .7 | .7 |
| 17 | Long-term private capital, net | −2.1 | −2.2 | −2.6 | −3.2 | [4] −3.3 |
| 18 | U.S. capital, net [5] | −2.5 | −2.6 | −2.9 | −3.6 | −3.6 |
| 19 | Foreign capital, net | .4 | .4 | .3 | .3 | [4] .3 |
| 20 | Short-term private capital, net | −1.4 | −1.4 | −.7 | −.8 | −2.0 |
| 21 | Errors and omissions | −.8 | −1.0 | −1.1 | −.3 | −.5 |
| 22 | *Balance on regular transactions* | −3.9 | −3.1 | −3.6 | −3.3 | −2.0 |
| | | | | | | *Unadjusted total* |
| 23 | *Balance on regular transactions before seasonal adjustment* | −3.9 | −3.1 | −3.6 | −3.3 | −1.5 |
| 24 | *Special Government transactions, net* | (6) | .7 | 1.4 | 1.3 | .4 |
| 25 | Debt prepayment and advances on military exports | (6) | .7 | 1.2 | .7 | .2 |
| 26 | Net sales of nonmarketable, nonconvertible bonds and notes | -------- | -------- | .3 | (6) | −.1 |
| 27 | Net sales of nonmarketable, convertible bonds and notes | -------- | -------- | -------- | .7 | .3 |
| 28 | *Balance including receipts from special transactions other than convertible securities* | −3.9 | −2.4 | −2.2 | −2.6 | −1.4 |
| 29 | *Balance including receipts from all special transactions* | −3.9 | −2.4 | −2.2 | −1.9 | −1.1 |
| 30 | Gold (decrease, +) | 1.7 | .9 | .9 | .5 | (6) |
| 31 | Convertible currencies (decrease, +) | -------- | −.1 | (6) | −.1 | (6) |
| 32 | IMF gold tranche position (decrease, +) | .4 | −.1 | .6 | (6) | .4 |
| | Changes in selected liabilities: | | | | | |
| 33 | To foreign central banks and governments (increase, +) | 1.4 | .7 | .5 | 1.0 | −.1 |
| 34 | To private holders and international and regional organizations (increase, +) | .3 | 1.1 | .2 | .6 | .9 |

[1] Excludes U.S. military grant aid and subscriptions to the IMF.
[2] Includes Government.
[3] Military expenditures abroad less military sales.
[4] Includes increase in U.S. Government liabilities associated with Columbia River development project.
[5] For detail see Table 8.
[6] Less than $50 million.

NOTE.—See Appendix Table B–79 for additional detail.
Details will not necessarily add to totals because of rounding.

Source: Department of Commerce.

economy could be an attractive magnet for private investment funds, thereby leading to an improvement in the U.S. capital account. While maintenance of the dollar as a strong reserve and trading currency required that major attention be given to the balance of payments, it was recognized that the strength of the dollar depends fundamentally on the continued vigor of the American economy in a setting of stable prices.

It was clear, however, that economic expansion alone could not bring about the needed improvement in our external position, particularly in view of continuing U.S. commitments for the defense of the free world and assistance to the developing countries. An array of special policy measures was thus required to permit simultaneous progress toward domestic expansion and external balance, in ways that would minimize any conflict with the basic longer-range U.S. goal of growing freedom in world trade and payments. Only a flexible and imaginative combination of a wide range of policy instruments could serve these purposes.

The various actions taken to raise domestic demand and to adapt monetary policy to the dual requirements of external balance and domestic expansion have been discussed above. Other measures taken in 1961 and 1962 and reinforced in mid-1963 included more direct efforts to stimulate exports, to reduce the Government's contribution to the payments deficit through its overseas expenditures, to reduce outflows of private capital, and to moderate the growth of tourist outlays abroad. New techniques were devised for financing the deficit in ways that would minimize gold outflows and strengthen confidence in the dollar. In addition, increased cooperation among financial and economic authorities here and abroad helped to strengthen the defense of international currencies against speculative attacks.

The record of the past four years has demonstrated the essential validity of this approach. While imports of goods and nonmilitary services did, in fact, rise by about \$5 billion, in line with the expansion of the domestic product between 1960 and 1964, exports of goods and services (excluding exports financed by the Government and including earnings on investments abroad) increased by nearly \$7½ billion. Gross outflows of Government capital have continued to rise moderately, but the net impact of all Government programs on the payments deficit has been reduced by about \$1.1 billion. The over-all improvement in the balance of payments attributable to these various factors approaches the total payments deficit in 1960.

Despite these gains, the decline in the deficit has been less rapid than had been hoped in 1961. The principal reason has been the relatively large rise in private capital outflows—an element of the balance of payments which might have been expected to advance less rapidly or even to decline in a period of rising domestic activity. While changes in the capital account are interrelated with other components in the balance of payments—for example, some capital outflows serve directly to finance our exports—and therefore should not be viewed in isolation, the over-all magnitude of capital outflows by mid-1963 had become clear cause for concern. This led to the adoption of special remedial measures, notably the imposition of the Interest Equalization Tax on purchases of new and outstanding foreign securities by U.S. investors.

In 1964, with foreign demands strong, the combination of influences and measures referred to above produced a continued reduction in the U.S. deficit on regular transactions. Further, this smaller deficit was financed to an unusually large extent by increases in private rather than official holdings of short-term balances, and outflows of gold were the smallest since 1957. Moreover, the strength of the multilateral currency arrangements worked out in recent years was dramatically demonstrated late in 1964 when, following a massive speculative attack against sterling, a $3 billion credit was extended to the United Kingdom by an 11-nation group and the Bank for International Settlements, with the United Sates taking a prominent part.

The progress achieved during 1964 further strengthened confidence in the dollar. Yet there are clouds in the record for the year that cannot be ignored and that raise new questions for the future. In particular, U.S. purchases of newly issued foreign securities as well as long-term bank loans to foreigners were unusually large in the latter part of the year, operating to produce a higher deficit in the fourth quarter.

The remainder of this chapter will deal with a number of key elements in the changing international position of the United States during the past four years: the gains in U.S. exports and in our competitive position; the reduction of net outflows on Government account; the shifting pattern of private capital flows; the development of new methods of financing our deficit; and the progress in international financial cooperation. The related discussion in Chapter 2 will then look toward the future of the U.S. balance of payments as well as toward the longer-range directions of international trade, aid, and financial arrangements and policies.

### GROWTH OF U.S. EXPORTS

The growth in U.S. exports during the past four years—and especially since the middle of 1963—has been a most welcome development. Between 1960 and 1964, commercial exports increased by $4.3 billion, and those financed by Government grants and capital accounted for a rise of nearly $1 billion more (Table 7). Although a small part of this growth must be attributed to special circumstances, such as extraordinary wheat sales to Eastern and Western Europe last winter, the expansion was, for the most part, broadly based in commodity composition and augurs well for the future. Moreover, it was widely spread around the world, with sharp increases to all major areas.

Several reasons explain the substantial improvement. Production and incomes have grown rapidly in most of the world, raising total world trade. Moreover, the competitive position of American products has been improved by price stability at home. These factors have been reinforced by various Government programs to promote exports and by the practice of tying an increasing proportion of U.S. foreign assistance funds to purchases in the United States.

The dollar value of free world exports rose at the rate of 6 percent a year from 1960 to 1963, and by 10 percent, or $14 billion, between mid-1963 and mid-1964. It is now double what it was only ten years ago. This increase in trade reflects continuing prosperity and economic growth abroad, particularly in Europe and Japan, and during the last two years in many raw material producing countries.

As the world's largest exporting and importing nation, the United States has benefited from the rapid growth in world trade. During the past year, however, not only have our total exports increased sharply; they have increased somewhat more rapidly than the exports of many of our competitors. Our recent export performance thus appears to reflect at least some improvement in our relative competitive position.

A full evaluation of changing competitiveness in world markets is, of course, extremely difficult. International competitiveness involves many dimensions. Quality, product design, promotion expenditures, financing arrangements, service facilities, delivery terms—all play some role in determining which exporter receives an order. But it is clear that the movement of U.S. prices relative to those of our competitors is a matter of great importance. And in recent years, the record of U.S. prices has been excellent. Since 1958, wholesale prices of industrial products have risen less in the United States than in any other industrial country—although devaluations in France and Canada helped to offset the impact of higher domestic prices on these countries' exports. Unit labor costs in manufacturing have also risen less here than in any other major country.

But while our domestic costs and prices have been more stable than those of our major competitors in recent years, our relative share of total world trade in manufactured goods—which had fallen rather sharply until 1959—continued to decline moderately for several years thereafter. This in part reflected the fact that movements of export prices differed in some countries from movements of over-all industrial prices. In addition, the creation of the European Economic Community (EEC) and the European Free Trade Association (EFTA)—which the United States welcomed—and the accompanying progressive elimination of internal tariff barriers within each group of countries were bound to result in increased trade within the EEC and the EFTA. This increase served to expand total international trade and tended to hold down or reduce the share, though not the total value, of exports from nonmember countries. However, the U.S. share of total world exports of manufactures, *excluding intra-EEC trade,* and its share of total exports of all commodities have been stable or slightly improving since 1959.

The apparent improvement in the competitive performance of American products has been aided by a number of Government programs to promote exports. The export expansion drive has assisted several thousand American firms to enter export markets for the first time. Through Trade

Centers and the sponsorship of commercial exhibits, the Department of Commerce has helped American businessmen to introduce their products abroad; the insurance and financing programs of the Export-Import Bank have been a further aid. Policies to promote price stability, reviewed in the next chapter, are obviously of utmost significance for the continuing growth of U.S. exports as well as for the improvement of our ability to compete with imports of manufactured foreign goods. But while all of these policies have proved helpful in stimulating exports, private initiative alone can provide the new and improved products, at moderate prices, which are essential to continuing strength in the American export position.

### GOVERNMENT PAYMENTS ABROAD

The major elements in the Government's payments abroad are military expenditures in support of our forces stationed overseas and grants and loans under foreign assistance programs. These are the transactions over which the Government is able to exert most direct control, and stringent efforts have been made to reduce their impact on the balance of payments.

Since 1960, net military expenditures abroad have been reduced from $2.7 to $2.1 billion, while direct payments abroad under Government economic assistance programs have been cut from $1.1 billion to $700 million—an over-all saving of $1 billion. This improvement has been brought about without curtailing assistance to the developing countries and without sacrificing military commitments to our allies, and despite repeated foreign crises which have required increased outlays for security. It reflects primarily the results and effects of a further tying of foreign aid procurement to U.S. sources, streamlining of our overseas military forces, and increased cash sales of military equipment to friendly countries.

### CAPITAL MARKETS AND CAPITAL FLOWS

While the over-all balance of payments position of the United States has shown definite improvement in the last four years, total net private U.S. capital outflows have registered a substantial expansion. As Table 8 indicates, they amounted to $4.2 billion in 1961, declined to $3.4 billion in 1962, but then rose again to a seasonally adjusted annual rate of $5.5 billion in the first half of 1963. Although a sharp reduction was recorded in the second half of 1963, net private capital outflows in 1964 were again very large and probably exceeded the 1963 total.

Large capital outflows have in part been required to finance growing U.S. exports. Moreover, the establishment of convertibility and the growing confidence in the continued freedom of international payments have led to a substantially greater international mobility of capital and a related tendency toward increased integration of international financial markets. In this context, our highly efficient, relatively low-cost, and readily accessible long-term borrowing facilities have undoubtedly tended to add to the net

TABLE 8.—*Recorded private United States capital outflows, 1960–64*

[Millions of dollars [1]]

| Type of capital | 1960 | 1961 | 1962 | 1963 First half | 1963 Second half | 1964 First half | 1964 Third quarter |
|---|---|---|---|---|---|---|---|
| | | | | Seasonally adjusted annual rates | | | |
| Total net capital outflows | 3,885 | 4,180 | 3,434 | 5,530 | 3,084 | 5,662 | [2] 4,867 |
| Long-term | 2,537 | 2,624 | 2,881 | 4,478 | 2,668 | 3,164 | [2] 3,655 |
| Direct investment | 1,674 | 1,599 | 1,654 | 2,190 | 1,586 | 2,184 | 2,076 |
| New issues of foreign securities | 555 | 523 | 1,076 | 1,858 | 642 | 682 | 564 |
| Redemptions | −201 | −148 | −203 | −186 | −204 | −184 | −152 |
| Transactions in outstanding securities | 309 | 387 | 96 | 302 | −204 | −268 | −148 |
| Long-term bank claims | 155 | 136 | 127 | 322 | 1,156 | 614 | 1,044 |
| Other long-term claims | 45 | 127 | 131 | −8 | −308 | 136 | [2] 271 |
| Short-term [3] | 1,348 | 1,556 | 553 | 1,052 | 416 | 2,498 | 1,212 |
| | | | | Unadjusted annual rates | | | |
| Bank credits | 610 | 912 | 327 | 122 | 782 | 1,010 | 372 |
| Commercial credits | 163 | 153 | 79 | 174 | 342 | 252 | 400 |
| Liquid funds | 579 | 454 | 175 | 622 | −516 | 1,114 | 208 |
| Other items | −4 | 37 | −28 | 24 | −82 | 12 | −168 |

[1] Outflow, +; inflow, −.
[2] Financing of $255 million to Canada for Columbia River power development is included but not multiplied in deriving the third quarter annual rate.
[3] Breakdown of short-term capital in part based on estimates by the Board of Governors of the Federal Reserve System.

Source: Department of Commerce (except as noted).

drain on our balance of payments. At the same time, the emergence of a highly developed international money market has greatly increased the volatility of interest-sensitive short-term funds.

Outflows of direct investment have shown a continuing rise; by 1964 they were one-third higher than in 1961. The share going to Western Europe also continued to expand; in 1964 it was approximately two-thirds of the total. The desire of American companies to establish or expand productive facilities close to rapidly growing European markets and inside the EEC tariff walls continued to provide the major incentive.

In contrast to this pattern of steady growth in direct investments, U.S. purchases of new foreign securities have undergone wide fluctuations in recent years. The volume of new foreign issues in our markets bought by Americans, which had averaged about $500–$600 million between 1959 and 1961, rose dramatically in 1962 to $1.1 billion and then in the first half of 1963 soared further to an annual rate of almost $2 billion. Following the Administration's announcement in July 1963 of its intention to ask for enactment of an Interest Equalization Tax, it dropped sharply to an annual rate of about $600 million and remained at this level until the autumn of 1964. After the actual enactment of the Interest Equalization Tax in September 1964, there was a renewed spurt of new security issues by Canadians (who are exempt from the Tax). However, for 1964 as a whole, both the total of new foreign security issues and Canadian borrowings were sharply below the rate reached in the first half of 1963.

Partly offsetting the decline in new issues of foreign securities has been a sharp rise in outflows of long-term bank credit since the spring of 1963. Whereas such loans had averaged about $140 million from 1960 to 1962, their adjusted volume reached an annual rate of almost $1 billion in the second half of 1963, without counting certain large takeovers of commercial claims from U.S. corporations. These outflows receded somewhat in the first half of 1964, but rose to new high records later in the year.

The burgeoning of long-term bank loans over the past year and a half clearly has reflected, among other factors, a spillover of demands from U.S. security markets following the Interest Equalization Tax proposal. Further impetus toward increases in such lending has been provided by tighter credit in a number of foreign countries as a result of restrictive measures taken in these countries early in 1964. These factors have also accounted for an important share of the substantial recent volume of short-term bank loans.

Outflows of U.S. owned liquid funds were very large in 1960, but receded between 1961 and 1962 as speculative pressures subsided and as short-term interest rates rose. Following the increase in the discount rate and in interest rate ceilings on time deposits in mid-1963, an actual inflow of liquid short-term funds was recorded.

During the early part of 1964, however, a gradual tightening of money market conditions abroad resulted in a renewed outflow of liquid U.S. funds to Canada and Europe. The total outflow of liquid funds subsided in the third quarter. Thereafter, the movement of these funds appears to have followed an irregular course in response to a variety of partly conflicting influences, including seasonal influences, the unsettlement of international money markets as a result of the sterling crisis, and the changes in central bank rates here and abroad.

### FINANCING THE DEFICIT

As has already been indicated, the long-run strength of the American dollar depends on the strength of the U.S. economy. More immediately, however, the strength of the dollar abroad is intimately related to the magnitude of the U.S. balance of payments deficit and to evidence that the deficit is being controlled and reduced. It also affects—and in turn is affected by—the manner in which the deficit is financed.

During the past several years, the United States, in cooperation with a number of countries in Western Europe, has developed a variety of new techniques for financing deficits and absorbing surpluses. These new mechanisms have reduced the pressure on the gold reserves of deficit countries and provided a greater variety of acceptable assets to surplus countries. Thereby, deficit countries have been given more adequate time to carry out necessary internal and external adjustments—within a framework of sustained growth and with minimum resort to measures inimical to the expansion of the free movement of goods and capital among nations. At the same time, surplus countries have been given greater opportunities for pursuing policies needed for orderly progress toward international payments equilibrium. The new financing measures are not, however, substitutes for progress in reducing the U.S. deficit.

In the past four years, there has been a striking shift in the roles played by changes in U.S. monetary reserves and in foreign holdings of short- and medium-term dollar liabilities in financing the remaining deficit. In 1960, a decline of over $2 billion in monetary reserve assets (mainly gold) financed more than half of our deficit, while liabilities to foreign official accounts also rose sharply. In 1964, however, despite a continuing deficit, the outflow of gold was small, and there was only a moderate rise in foreign official holdings of liquid claims on the United States. Instead, partly as a result of more attractive short-term interest rates in the United States and continuing confidence in the dollar, foreign private businesses (including commercial banks) and individuals added to their holdings of liquid dollar assets. Such additions to private holdings of dollar assets in the United States financed about half of the U.S. deficit on regular transactions in 1964.

To mitigate mounting balance of payments difficulties, the United States began in 1959 to arrange for substantial advance repayments on loans made to its European allies in the immediate postwar period. These advance repayments have continued. Since 1962, the United States has also sold special medium-term, nonmarketable securities to foreign governments. These bonds and notes, frequently denominated in the holder's currency, offer an attractive alternative to further accumulation of gold or short-term liquid dollar assets in the official reserves of surplus countries.

In addition to these special bilateral arrangements, the United States began last year to make more direct use of the International Monetary Fund (IMF), by drawing foreign currencies and selling them to countries wishing to repay the Fund. Such IMF transactions, in effect, financed (net) about $260 million of the U.S. deficit in 1964.

Neither our use of IMF resources nor the conclusion of special transactions with surplus countries has directly reduced the U.S. deficit on regular transactions. However, our ability to negotiate such arrangements and other countries' willingness to participate in them have been both a reflection and a source of confidence in the dollar.

## BROADENED INTERNATIONAL FINANCIAL COOPERATION

The success of the United States in reducing its deficit and in developing improved methods of financing the deficit that still remains has helped to create an atmosphere conducive to increased cooperation among the world's central banks and financial officials. Such cooperation, in turn, has strengthened the existing network of international monetary arrangements.

Within the past few years the facilities of the IMF have been broadened, and agreement has been reached on the advisability of an increase in its resources. In addition, the major industrial countries included in the "Group of Ten" have declared their readiness to supply to the IMF up to $6 billion of additional convertible currencies under the provisions of the General Arrangements to Borrow; these supplementary facilities were first utilized in 1964 in connection with the provision of IMF assistance to the United Kingdom. Moreover, a network of reciprocal currency, or "swap", arrangements among the major central banks has been developed since 1962, primarily as a means of dealing with temporary speculative pressures. Such currency swaps make possible flexible and coordinated intervention in both spot and forward foreign exchange markets by monetary authorities in the several countries. At the same time, the international gold pool has served to reduce speculation in gold markets and thus helped to conserve gold for monetary use. Frequent consultation among treasury and central bank representatives of the major industrial countries has improved the ability of these officials to respond smoothly and effectively to actual or potential disturbances in the international exchange markets.

During the past year, the capacity of these strengthened international arrangements to deal decisively with sudden or sustained pressures against major currencies was put to two severe tests. In March, the United States, together with the IMF and several European countries, moved quickly to provide a $1 billion package of credit to shore up Italy's then shaky balance of payments; and, as noted earlier, a series of cooperative arrangements was worked out in November to alleviate pressures on the British pound.

Cooperation among financial and economic authorities throughout the world is, of course, also needed to create conditions that will discourage the development of such pressures in the first instance. Cooperation can foster a smoother and more responsive process of balance of payments adjustment within an environment conducive to economic growth and increased freedom of international trade and payments. Progress along these lines has been made in recent years through frequent and constructive discussions in a variety of forums, including the IMF, committees of the Organization for Economic Cooperation and Development, and the monthly meetings of central bank governors at Basle held under the auspices of the Bank for International Settlements.

Encouraging as these steps toward greater international monetary cooperation have been, it is clear that much remains to be done to improve the process of international payments adjustment and that there is scope for further strengthening of existing cooperative arrangements as well as the international monetary mechanism. Various proposals designed to accomplish these purposes are discussed in Chapter 2.

## Chapter 2

# Sustaining Prosperity in 1965 and Beyond

LAST YEAR, responding to the largest fiscal stimulus ever provided in peacetime, businesses, workers, and consumers moved the American economy strongly forward toward full realization of its vast productive potential. The year 1965 promises to be the fifth year of continued economic expansion—an unprecedented record—bringing further substantial gains in output, personal incomes, and corporate profits. Yet, as the year opens, unemployment remains too high and will continue to be our major economic problem. As a consequence, Government policies must still be directed to closing the existing gap between current production and potential.

Meanwhile, the Nation's economic potential will be expanding rapidly as productivity forges ahead and as record numbers of young people enter the work force. Policies to provide education and skills are vital to help them meet the needs of today's labor market. It is essential that these young people enter the ranks of the employed. If this challenge is met, the new workers will become eager consumers, helping to maintain high employment levels with their demands for houses, cars, and other goods and services. Partly because of their spending, private demand may become somewhat stronger than it has been in the recent past. But the prior requirement and the continuing need are for expansionary fiscal and monetary policies that will help to open job opportunities for new labor force entrants and for the currently unemployed. The prospects for 1965 and available clues for the longer run are analyzed below, followed by an evaluation of the policies required to capture the benefits of our expanding economic potential.

Our best defense against recurrent recession is a strong offense—constant efforts to sustain expansion through general fiscal and monetary measures. But recessions do not always cast their shadows far in advance. Insurance is needed against a sudden downturn. By planning now for tax and expenditure measures that can be quickly enacted and executed should the need arise, we can lessen the possibilities of recessions and minimize their severity should they occur.

Full employment and rapid growth must be pursued along with reasonable price stability. It is essential that the notable recent parallel between private wage-price decisions and the public guideposts be maintained. The significance of wage-price decisions for the achievement of all our economic goals is discussed later in this chapter.

Prospects and policies for the domestic economy must also take account of international economic objectives. The final section of this chapter considers the requirements for policies to improve the balance in our international transactions, to remove barriers to world trade, to aid less developed countries, and to strengthen the international monetary system.

A recurrent theme of the chapter is that the task of moving toward several goals is far more demanding than the single-minded pursuit of just one. In order to attain our domestic production and employment goals in a climate of price stability, and at the same time to progress toward a better international economic order, we must make the wisest use of the full range of policy instruments.

## THE GAP BETWEEN ACTUAL AND POTENTIAL GNP

The economy today has room for—and need for—more employment and more production. The Employment Act's objectives of "maximum production" and "maximum employment" can only be achieved together. Unemployment is wasted manpower. Moreover, idle men are generally accompanied by idle machines. Thus, when the economy is marked by excessive unemployment, it is producing below its full potential. The distance between our actual and our potential gross national product (GNP) is one measure of the cost of high unemployment to the whole Nation.

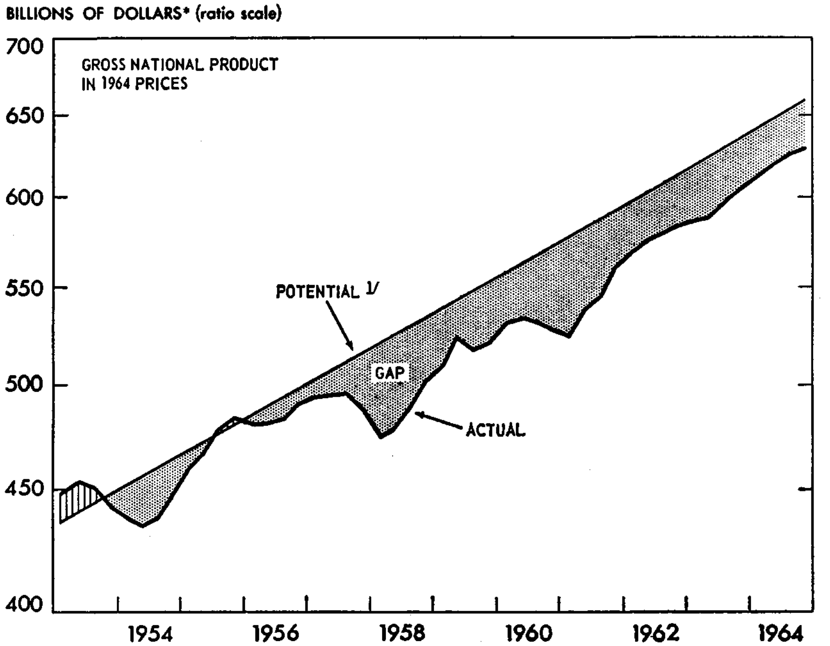
The potential GNP of the U.S. economy measures the volume of goods and services that our economy could produce if the unemployment rate were at the interim target of 4 percent. Potential GNP cannot actually be observed when unemployment is above 4 percent; and to estimate it is an inherently difficult task. Even the best use of available data and of statistical and economic techniques will leave a margin of error in the calculation. Nevertheless, decisions on policies to stimulate or restrain the over-all level of economic activity require a judgment on the gap between current and potential production.

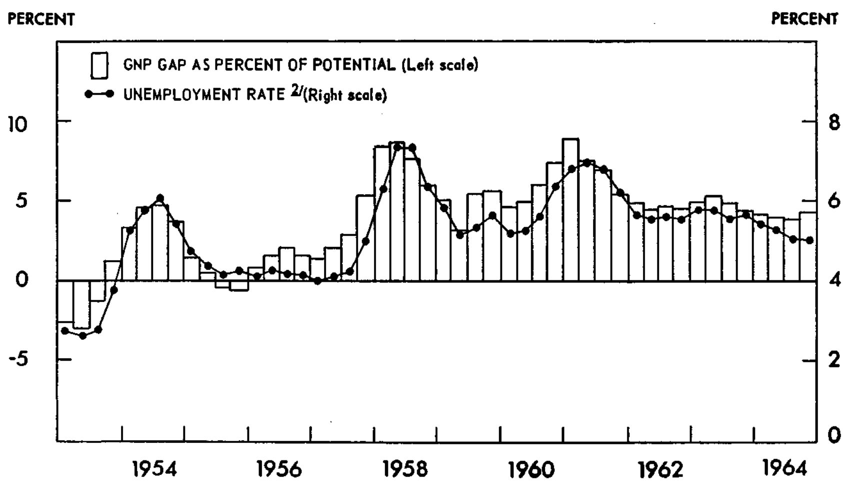
The Council has continuously examined the current and prospective growth of potential in light of new data and emerging developments in the economy. In its past three Annual Reports, the growth of potential GNP since mid-1955 has been approximated by a trend line rising at a rate of 3½ percent a year. It now appears that the growth of potential has recently stepped up: A real growth rate of actual GNP somewhat greater than 3½ percent has been required to prevent a rise in the unemployment rate.

The precise causes of the recent pattern are not definitely established. We may have already begun to experience a more rapid growth of the labor force; the growth trend of productivity may have increased modestly; or these two factors may have operated in combination. Nor is it yet clear just when the recent pattern began. Despite these unsettled issues, the best estimate of recent potential growth must be placed somewhat above 3½ percent and below 4 percent. In line with this conclusion, Chart 12 shows the growth rate of potential GNP as 3½ percent from 1955 through 1962 and 3¾ percent thereafter.

Chart 12

# Gross National Product, Actual and Potential, and Unemployment Rate




*SEASONALLY ADJUSTED ANNUAL RATES.

1/ 3½% TREND LINE THROUGH MIDDLE OF 1955 TO 1962 IV; 3¾% TREND LINE THEREAFTER.

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

SOURCES: DEPARTMENT OF COMMERCE, DEPARTMENT OF LABOR, AND COUNCIL OF ECONOMIC ADVISERS.

Potential GNP includes the output that could be produced by people who would leave the ranks of the unemployed and also by many who are not currently counted in the labor force but who would be at work if unemployment were reduced to 4 percent. Some people who are ready and willing to work have concluded that jobs are not available; they are not actively seeking employment and are therefore not counted as unemployed. According to past evidence, such "hidden unemployment" is concentrated among women, young males, and older men. Men in the 25–54 age bracket have a permanent attachment to the labor force; their labor force participation rates remain close to 97 percent regardless of changes in the availability of jobs. Participation rates of all the remaining age-sex groups are substantially lower and are sensitive to changes in employment opportunities. These relationships are indicated in Chart 13 which shows labor force participation rates and the corresponding employment-population ratios each year since 1952 for males aged 25–54 and for all other age-sex groups combined.

Furthermore, productivity would be higher in a full-employment economy than it actually is today; this is also reflected in the estimate of potential GNP. In periods of underutilization, output per worker is depressed because of the overhead nature of some clerical, professional, and managerial employment and because plant and equipment are being operated at inefficient rates. During periods of movement toward full employment, rapid gains in productivity reflect the fact that both workers and machines are operating more fully and more efficiently.

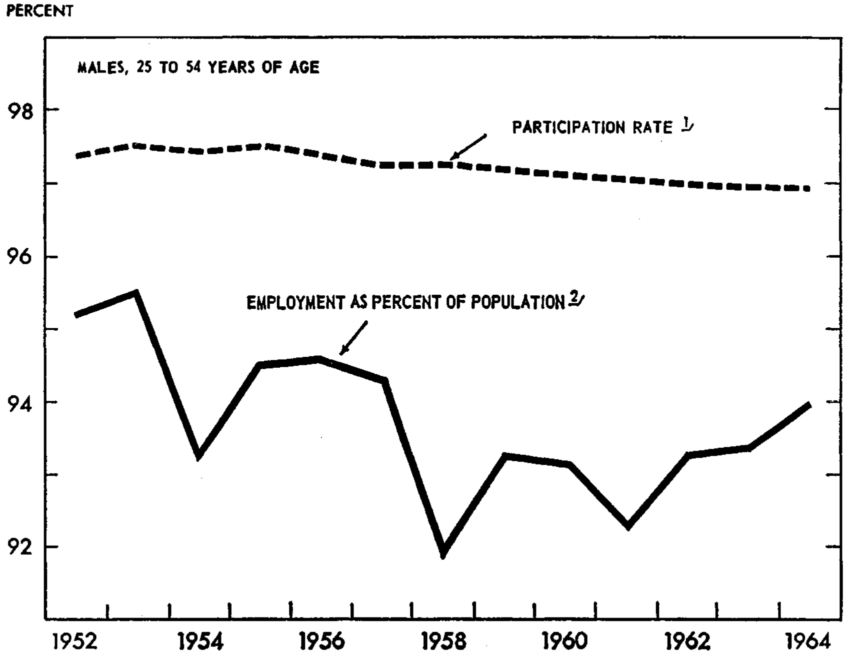
Actual GNP for 1964, at $622 billion, was $27 billion or 4 percent below estimated potential. In the first quarter of 1961, the gap was $51 billion (in 1964 prices) or 9 percent of potential. Thus, the current expansion has substantially narrowed the gap; its present size indicates the remaining distance to full realization of potential.

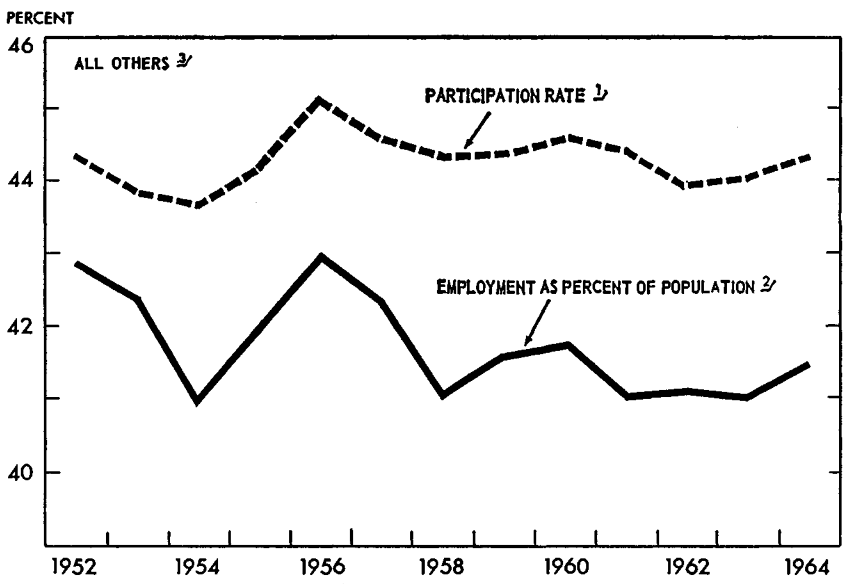
The Council's estimate of potential GNP reflects the belief that the economy could operate at a 4 percent unemployment rate today without substantial strains on either labor supplies or plant capacity. Operating rates in industry show the presence of capacity to fill additional demands. Labor supplies are generally abundant in most labor markets. While unemployment rates vary widely among different age-sex groups in the population, rates are consistently above those of 1956, when the over-all unemployment rate was 4.2 percent.

The ease of attaining a given global unemployment rate can be affected by major shifts in the composition of the labor force. Some groups, like teenagers and uneducated adults, typically have relatively high unemployment rates; a large increase in their numbers relative to the total labor force would be expected to make the attainment of a given over-all unemployment goal more difficult. In fact, there have been moderate shifts in the composition of the labor force in the direction of *age-sex groups* with typically higher unemployment rates. But there have also been shifts toward

Chart 13

# Labor Force Response to Employment




1/ PERCENT OF NONINSTITUTIONAL POPULATION IN THE LABOR FORCE (INCLUDES ARMED FORCES).
2/ PERCENT OF NONINSTITUTIONAL POPULATION HAVING EMPLOYMENT (INCLUDES ARMED FORCES).
3/ INCLUDES FEMALES, 14 YEARS OF AGE AND OVER; MALES, 14 - 24 YEARS AND 55 YEARS AND OVER.
SOURCE: DEPARTMENT OF LABOR.

*education groups* with lower unemployment rates. If every *age-sex group* now had the same unemployment rate it experienced in March 1957, the over-all unemployment rate would be 0.2 percent *higher* than it was then. On the other hand, if every *education group* now had the same unemployment rate it experienced in March 1957, the global unemployment rate would be 0.3 percent *lower* than it was then.

The interim target of a 4 percent unemployment rate is attainable, given the required level of demand for goods and services. By improving labor market information, skills, and formal education, the manpower policies discussed in Chapter 3 can facilitate the transition to a 4 percent unemployment rate and can, in the future, let us attain even lower rates.

## OUTLOOK FOR 1965

Evidence on the economic outlook for GNP and prices has helped to guide the formulation of this year's economic policy proposals. In turn, the President's program has an important influence in strengthening the prospects for sustained prosperity with price stability in 1965.

### PROSPECTS FOR GROSS NATIONAL PRODUCT

With congressional enactment of excise tax reduction, social insurance liberalization, and other key fiscal proposals as scheduled in the President's program, GNP for 1965 is expected to lie within a $10 billion range centering on $660 billion. At the midpoint of this estimated range, the dollar growth in GNP this year would equal the increase of $38 billion in 1964. But because GNP has risen in the past year, matching the dollar gain of 1964 would mean a percentage increase about half a point less than the 6½ percent registered in 1964. In constant prices, the increase in output is likely to exceed the growth of potential, reducing the gap moderately.

The range from $655 billion to $665 billion recognizes the limited precision of economic forecasting. Although the midpoint of the projected range in the Council's last Annual Report was within $1 billion of actual GNP for 1964, such accuracy cannot be counted on every year. Economists are still far from a complete understanding of the determinants of consumer and business spending. Nor do they yet have completely accurate measures of recent trends and levels of economic activity, so important to an assessment of the near future. Moreover, unforeseen events external to the domestic economy can have important effects on business activity. The evident shortcomings and pitfalls in forecasting highlight the need for constant surveillance of changes in output and employment and for flexibility in economic policy.

The available evidence points to new gains in expenditures by consumers, businesses, and governments. The increases in the components should reinforce one another; they sum up to the prospective increase in GNP.

*Government.* Purchases of goods and services by State and local governments are likely to be nearly \$5 billion higher than in 1964, maintaining their recent upward trend and benefiting from further expansion of Federal grants-in-aid. Federal purchases of goods and services are expected to increase by about \$½ billion this year. In fact, 1965 will mark the first year since 1950, and only the second year since 1940, in which State and local purchases will exceed those of the Federal Government.

*Business fixed investment.* Business outlays for durable equipment and new construction were stronger in 1964 than surveys of business intentions had initially indicated. Prospects are excellent for a further expansion in 1965. Capacity utilization rates in manufacturing, although still below preferred levels in almost all industries, are above those of a year ago. These improved rates, together with the sales increases expected by manufacturers, validate the investment made in 1964 and provide incentives for further expansion. In addition, lower corporate taxes have raised the after-tax yield of investment. Furthermore, the gross cash flow retained by business remains high in relation to capital outlays, thus permitting new investment to be financed with comparative ease.

The survey of intentions to invest--jointly conducted by the Department of Commerce and Securities and Exchange Commission—indicates that new plant and equipment expenditures in the first half of 1965 will be approximately \$3½ billion (annual rate) above those in 1964. For the year as a whole, the advance in business fixed investment should come close to, but probably not match, last year's rise of \$5½ billion.

*Inventory investment.* Inventory accumulation in 1964 was surprisingly modest. Indeed, despite the stronger gains in final sales, such investment was lower in 1964 than in 1963. Inventories today seem unusually conservative relative to prospective sales, and are expected to rise somewhat more rapidly this year. Accumulation may exceed last year's rate by about \$2 billion.

*Residential construction.* The value of residential construction in 1964 was \$1 billion higher than in 1963, but it moved downward during the course of the year. It seems unlikely that outlays for home building this year will substantially exceed those in 1964: housing starts in the final quarter were a little below the annual average; overbuilding of apartments occurred in some localities. On the other hand, sales of new single-family homes have held up well and basic forces appear strong enough to prevent a further decline in home building. Family incomes are high and rising. With a plentiful supply of funds on hand, savings and loan institutions and other financial intermediaries will continue to welcome qualified mortgage loan applicants. Although the number of housing starts may be lower than in 1964, the average value per start is likely to rise. Thus, total outlays on new private residential construction in 1965 are expected to show little change from 1964.

*Consumption expenditures.* Consumption expenditures are likely to rise at a slightly more rapid rate than disposable personal income. Full adjustment to the tax cut should bring down the saving rate below the 7½ percent of 1964. The excellent reception of the 1965 auto models and the continued strength of used car prices augur well for new car sales. The exceptionally strong rise in household durables last year is not likely to be duplicated in 1965, though sales should advance further. The proportion of consumption composed of services and nondurable goods is likely to rise in 1965 from its 1964 value.

In 1964, disposable income was boosted substantially by the tax cut; this year, less fiscal stimulus is in prospect. Gains in household purchasing power will depend mainly on incomes generated by advances in the expenditure categories discussed above. In all, increases in consumption expenditures should account for about two-thirds of the rise in GNP.

### *Quarterly pattern*

The pattern of advance during the course of this year will have an important influence on the continued balance of the expansion. Backlogs of demand resulting from the strikes in the automobile industry in the autumn of 1964 are likely to add strength to over-all production in the current quarter. On the other hand, Federal fiscal measures, including the excise tax reduction and social insurance liberalization, should strengthen the advance in the second half of this year. While the outlook for business fixed investment and consumer buying inclinations is necessarily more uncertain for the later months of the year, the evidence does not suggest a weakening.

Conditions in the steel industry present the chief visible threat to prospects for a balanced pattern of quarter-to-quarter advances. Manufacturers are likely to continue to augment their stocks of steel during the next few months as a defense against a possible strike after May 1. In the event of a strike, added inventories of steel would provide a useful reserve, permitting continued production of fabricated products. Nevertheless, a steel strike of significant duration would have unfavorable effects on over-all income and production, as the economic annals of 1956 and 1959 demonstrate.

If a collective bargaining settlement is reached near the deadline without a work stoppage, stocks of steel will be reduced during the second half of the year. Under such conditions, a rapid rise in activity during the next few months might be followed by much smaller advances during the rest of the year, possibly accompanied by increasing unemployment. It is particularly difficult for economic policy to deal with such a transitory situation—either on the upside or the downside. Thus, a prompt and responsible settlement in the steel industry is important for sustained, balanced advance in 1965.

*Employment*

Expected output gains in 1965 are likely to increase employment substantially, but not quite as much as last year, when more than 1.5 million jobs were created. The expected increase in the labor force is nearly as large as the prospective gain in jobs; normal demographic trends are expected to bring in 1.3 million net new entrants and recent improvements in job opportunities may add to that number. Some decline from the 5.2 percent unemployment rate of last year is likely in 1965.

## OUTLOOK FOR PRICES

The size of the existing gap and the prospects for GNP suggest that widespread pressures on the supply capabilities of the economy are not likely to emerge this year. There are good prospects for extending in 1965, our recent record of price stability, just as it was maintained last year when production accelerated and unemployment declined. Wholesale prices are more volatile than consumer prices, and they are likely to show earlier movements. For this reason, the discussion below is concentrated on the outlook for wholesale prices this year.

The industrial component of the wholesale price index rose by 0.6 percent between the fourth quarter of 1963 and the fourth quarter of 1964. This increase was modest, particularly when compared with the rise of 3.2 percent a year between the final quarters of 1954 and 1957. But it was the largest rise over four quarters since early in 1960, and raised wholesale industrial prices back to the peak reached at that time. Hence, it is important to ask whether these prices have begun a renewed upward trend. The significance to be attached to the recent movements depends in part on their breadth, the character of the force behind them, and the indirect effects they might be expected to have on other prices.

An examination of price movements during the past year in the major industrial commodity groups (Table 9) shows that the over-all rise in average wholesale industrial prices was primarily the result of large price increases in nonferrous metals and in steel scrap. These two groups together account for an increase in the industrial index equal to nine-tenths of the total rise. In large part, the rise in nonferrous metal prices reflected curtailment of supplies as a result of strikes and political crises affecting important world production centers. These price increases have already spread to fabricated metal products.

The only other major commodity group to contribute more than 0.1 percentage point to the rise in the over-all index was nonelectrical machinery. The price rise for this group was 1.6 percent during the past year. Because of the low rate of productivity advance in this industry, prices have typically risen, with increases averaging 1.0 percent annually in the last several years.

Price movements of the remaining commodity groups were almost evenly divided between rises and declines, and generally consistent with their pattern of recent years. The steady downward trend in prices of electrical machinery and equipment, petroleum, and rubber products contrasts with their upward direction in previous expansions.

TABLE 9.—*Changes in wholesale industrial prices, by major commodity groups, fourth quarter of 1963 to fourth quarter of 1964*

| Commodity group | Weight in total industrial index (percent) [1] | Change in price index, 1963 IV to 1964 IV | |
|---|---|---|---|
| | | Percentage change | Contribution to total change (percentage points) |
| Total industrial products | 100.00 | 0.6 | 0.59 |
| Metals and metal products [2] | 17.14 | 3.2 | .54 |
| Nonferrous metals and scrap (excluding aluminum) | 3.00 | 13.9 | .42 |
| Iron and steel scrap | .42 | 28.6 | .12 |
| Semifinished and finished steel | 4.56 | −.7 | −.03 |
| Aluminum ingot, mill shapes and fabricated products | 1.20 | .7 | .01 |
| Nonelectrical machinery | 9.64 | 1.6 | .15 |
| Textile products and apparel | 10.32 | .4 | .04 |
| Chemicals and allied products | 8.88 | .9 | .08 |
| Motor vehicles and parts | 6.69 | .8 | .05 |
| Passenger cars, trucks, and busses | 5.30 | −.7 | −.04 |
| Motor vehicle parts and accessories | 1.38 | 6.6 | .09 |
| Hides, skins, leather and products | 1.85 | 2.2 | .04 |
| Lumber and wood products | 3.62 | .6 | .02 |
| Furniture and household durables | 5.38 | .4 | .02 |
| Nonmetallic mineral products | 3.79 | .5 | .02 |
| Tobacco and beverage products | 3.23 | .0 | .00 |
| Pulp, paper, and allied products | 6.44 | −.4 | −.03 |
| Electrical machinery | 6.25 | −1.1 | −.07 |
| Miscellaneous products [3] | 4.54 | −1.3 | −.06 |
| Rubber and products | 1.97 | −2.1 | −.04 |
| Fuels and related products, and power | 10.36 | −1.2 | −.13 |

[1] As of September 1964 with 1958 quantity weights.
[2] Includes some groups not shown in this table.
[3] Includes transportation equipment other than motor vehicles and parts.

NOTE.—Detail will not necessarily add to totals because of rounding.

Source: Department of Labor.

These facts indicate that the recent increases in wholesale industrial prices should not be viewed as a harbinger of further advances this year. The ample capacity for expansion of output in most manufacturing industries is shown by Table 10. Actual operating rates in December 1964 exceeded preferred rates in only rubber and textiles, although nearly all industries were using more of their capacity than a year earlier. The rubber industry benefited from record automobile production, while new cotton legislation enabled the textile industry to compete more effectively with imports while expanding exports. Despite high operating rates, prices in both of these industries declined in 1964.

Twelve of the industries, including all durable goods industries except nonferrous metals, can still increase operating rates by 2 or more points before reaching preferred levels. Moreover, most industries have been steadily increasing capacity; and the planned levels of manufacturing investment for 1965 point to continued rapid expansion of capacity, sufficient to produce the expected gains in output without significant increases in operating rates.

TABLE 10.—*Operating rates and backlog of unfilled orders in manufacturing industries: 1963 and 1964*

[As of December]

| Industry | Operating rate (percent) [1] | | Preferred operating rate (percent) [2] | Preferred rate less operating rate (percentage points) | Backlog of unfilled orders (months) [3] | |
|---|---|---|---|---|---|---|
| | 1963 | 1964 | | 1964 | 1963 | 1964 |
| Total manufacturing | 85 | 88 | 92 | 4 | 2.36 | [4] 2.52 |
| Iron and steel | 70 | 88 | 91 | 3 | 1.35 | 2.09 |
| Nonferrous metals | 90 | 95 | 95 | 0 | | |
| Machinery | 82 | 88 | 91 | 3 | 2.65 | 2.89 |
| Electrical machinery | 78 | 84 | 93 | 9 | 2.93 | 3.08 |
| Autos, trucks, and parts | 89 | 94 | 96 | 2 | | |
| Other transportation equipment | 80 | 79 | 88 | 9 | | |
| Fabricated metals and instruments | 84 | 88 | 92 | 4 | 2.37 | 2.64 |
| Chemicals | 80 | 79 | 90 | 11 | | |
| Paper and pulp | 90 | 93 | 97 | 4 | | |
| Rubber | 92 | 96 | 94 | −2 | | |
| Stone, clay, and glass | 77 | 79 | 88 | 9 | | |
| Petroleum and coal | 90 | 93 | 95 | 2 | | |
| Food and beverages | 80 | 79 | 86 | 7 | | |
| Textiles | 95 | 97 | 96 | −1 | | |
| Miscellaneous manufacturing | 88 | 86 | 94 | 8 | | |

[1] Output as percent of capacity. Data for 1963, excluding iron and steel, from McGraw-Hill; estimates for iron and steel in 1963, and all industries in 1964, by Council of Economic Advisers, after consultation with McGraw-Hill, Department of Economics.
[2] McGraw-Hill survey data for December 1962, the latest available.
[3] Ratio of unfilled orders to shipments (seasonally adjusted) for those industries for which detail is available.
[4] November.

Sources: McGraw-Hill Publishing Company, Department of Commerce, and Council of Economic Advisers.

The ease with which manufacturing industries have been meeting rising demands is also indicated by the relatively mild increases in the ratio of order backlogs to shipments from December 1963 to December 1964. These increases, following declines during 1962 and 1963, left over-all manufacturing backlogs no higher relative to shipments than at the end of 1961. On the basis of the prospects for GNP reviewed above, backlogs would not be expected to grow significantly in most industries this year.

Continued stability of unit labor costs during the current expansion (reviewed in Chapter 1), and particularly in manufacturing from 1963 to 1964, has helped to hold down prices. Prospective labor supplies should assure against any widespread tightness in labor markets and should exert a restraining influence on wage settlements. Moreover, the current concern with work rules and job security tends to reduce the "pattern-setting" effect of large wage settlements in key industries.

Furthermore, the revised depreciation guidelines, investment tax credit, and corporate tax reduction have strengthened after-tax cash flow in many industries and aided price stability. For example, the contribution of these

Federal fiscal measures to cash flow in the steel industry was the equivalent of a 3 percent price increase in 1964.

Thus, many important factors are working to preserve wholesale price stability. Price increases from demand pressures are likely to be limited to a few specialized areas, such as occurred in nonferrous metals in 1964; and price reductions can be expected elsewhere—particularly in industries with rapidly increasing productivity. But there are areas in the economy where management and labor possess the market power to exercise some discretion in their price and wage decisions, and, in particular, to make inflationary decisions even in the absence of excess demands. With responsible decisions by business and labor, 1965 should see continued price stability.

## GROWTH PROSPECTS FOR THE LONGER RUN

The growth of potential GNP depends on long-run demographic, economic, and technological factors that are partly beyond the control of public and private policies. But it is also influenced by a variety of public and private decisions that can and should be made with a view to their effect on the growth of productive capacity. Some of these policies are referred to below. Growth rates of potential output vary from country to country, and in our own history they have differed considerably from period to period. Potential GNP grew rapidly in the early postwar years and then more slowly after the Korean conflict. Under current policies, potential output seems to be accelerating and will probably continue to speed up between now and 1970, reflecting the increases in labor force and long-run productivity.

### LABOR FORCE

The labor force is expected to grow much more rapidly during the remainder of the 1960's than it has in recent years. Apart from increases in participation rates that would be induced by improved employment opportunities, the expected annual growth to 1970 is 1.7 percent, or about 1.4 million persons, a major acceleration from the yearly average of 1.2 percent, or 0.9 million persons, in the past nine years.

Different age-sex groups are expected to grow at different rates. The projected increase in the number of males between the ages of 25 and 54 years is only 0.7 percent a year from 1964 to 1970. The rest of the labor force—all female participants and male participants aged 14 to 24 and 55 years or more—will be increasing at the much higher rate of 2.4 percent. The fraction of the total labor force made up by males in the 25–54 age group fell from 45 percent in 1955 to 42 percent in 1964. And this downward trend will continue during the remainder of the 1960's. The tremendous growth of the other groups presents an important challenge to the manpower policies discussed in the next chapter, since these groups may be more difficult to absorb into the ranks of the employed. The more rapid over-all expansion of the labor force will increase the growth rate of potential output in the years ahead. It emphasizes the economy's need for—and its capacity to meet—a steady and substantial growth of demand.

### PRODUCTIVITY

Productivity has increased rapidly in the current expansion. But this is typical of a period of improving utilization rates, since labor and capital are used more efficiently. The recent performance does not provide clear evidence that the long-run trend of productivity growth has changed, but there is some evidence that it may have risen slightly in recent years.

A gradual improvement in the trend of productivity growth may be expected from our sustained expansion and higher investment. Higher rates of investment increase the quality as well as the quantity of available productive capital, since the latest technology is embodied in new machinery and equipment. Periods of expansion are also favorable to the introduction of new and improved products and processes that may raise productivity without requiring substantial capital investments.

While all these factors have effects that are predictable at least in direction, their quantitative impact is gradual and defies careful measurement.

The prospects for growth of the labor force and productivity suggest that the increase of potential GNP in 1965–70 will exceed the 3½ percent annual rate of the 1955–62 period and even the 3¾ percent rate estimated currently. Indeed, over the next five years it is likely to average about 4 percent a year, a rate approaching that of the early postwar period.

In the long run, with policies promoting growth as well as full utilization, it should become possible and desirable to surpass even this growth rate.

### PRIVATE DEMAND

Whether our rapidly growing potential GNP will be fully realized as actual GNP during the remainder of this decade will depend upon the strength of aggregate demand. And aggregate demand, in turn, will reflect both Federal policies and the strength of spending by other sectors—households, businesses, and State and local governments. The buoyancy of private spending will determine whether Federal policies need to be relatively expansionary or restrictive in pursuing full employment with stable prices.

Fluctuations in the long-term strength of private demand have changed the tasks of Federal policies in the past. During 1947–53, private demand was exceptionally strong and restrictive government policies were needed much of the time to keep demand from pressing too hard on capacity.

The United States emerged from World War II with depleted and aging stocks of homes, household durable goods, automobiles, and plant and equipment, reflecting the low levels of private investment during the Great Depression and the wartime emergency restrictions on civilian purchases. The war also generated a large accumulation of liquid assets by consumers and business firms. With a strong desire for rebuilding and updating their stocks of durable goods and with the financial ability to translate this desire into effective demand, the American consumer and businessman were eager spenders. The military and industrial build-up associated with the Korean conflict intensified the ebullience of the economy and prolonged the adjustment of stocks into the 1954–57 period.

The economic environment since 1957 has differed significantly from that of the previous decade. A persistent gap has developed between potential GNP and actual GNP. The immediate reasons for the existence of this gap are fairly evident. First, restrictive full-employment surpluses in the Federal budget emerged. Second, private demand has not been sufficiently buoyant to overcome the fiscal drag of these potential surpluses. There has been no accumulated backlog of demand for housing, consumer durable goods, or business capital. And—although there has been no dearth of youngsters and oldsters—the number of new families in the market for houses, furniture, appliances, and cars has grown at only a modest pace.

We are now on the threshold of a more rapid increase in the number of persons reaching working age. Just as this will accelerate the potential output of the economy, so too will it add to the underlying strength of private demand for a range of business and consumer investment goods.

There is no assurance, however, that the increase in effective demand for goods and services will synchronize precisely with the added productive potential represented by the surge of new entrants to the work force. Indeed, the demographic patterns for the next decade, coupled with information on the broad spending habits of different age groups, suggest that the strengthening of private demands will be most significant in the 1970's. But these projections also suggest there should be a steady, if less spectacular, growth in private demand during the remainder of this decade. There is also a promising possibility that private demand will be stimulated by the sharply rising research and development expenditures of recent years.

*Spending by individuals*

The forthcoming changes in the age-structure of the population will have their primary influence on over-all demand by affecting spending for durables and housing. Purchases of new houses almost invariably involve a large element of long-term credit. Since this is repaid gradually out of normal saving, the homebuyer is not obliged to curtail his current consumption expenditures. Purchases of cars and household durable goods are typically financed by credit or past savings, and expenditures on these durables may in part add to, rather than replace, other types of spending. Thus, particularly strong demand for houses and durables can raise total spending by individuals relative to total income.

757-981 O—65——7

Individuals are most likely to be in the market for homes and durables in the period between marriage and the age at which their children are grown. On the other hand, families in the 45–64 age group are likely to be high savers, with the major need for durables behind them and the prospects of retirement coming into view. When people retire, they generally have low current incomes and draw down their life savings, thereby once again contributing to demand relative to their incomes.

The high birth rates of the postwar period will strengthen the demand for automobiles sooner than they will affect housing; indeed, they have already helped to invigorate both new and used car markets. The first postwar babies are already of driving age and, in the last half of this decade, the number of persons in the 20–24 age group will rise sharply (Table 11). The favorable population factor, continued preferences for multiple-car ownership, and a large volume of replacement demand (now about 5½ million a year) will all contribute to a rising potential demand for automobiles during the rest of the 1960's and into the 1970's.

TABLE 11.—*Population 20 years of age and over, by selected age groups, 1960 estimate, and 1965–75 projections*

[Millions of persons; as of July 1]

| Age group | 1960 estimate | Projections | | |
|---|---|---|---|---|
| | | 1965 | 1970 | 1975 |
| Total, 20 years and over [1] | 111.1 | 117.6 | 126.8 | 137.2 |
| 20–24 years | 11.1 | 13.6 | 17.1 | 19.1 |
| 25–34 years | 22.9 | 22.4 | 25.2 | 31.1 |
| 35–44 years | 24.2 | 24.5 | 23.0 | 22.5 |
| 45–64 years | 36.2 | 39.0 | 41.9 | 43.4 |
| 65 years and over | 16.7 | 18.1 | 19.6 | 21.2 |

[1] Includes armed forces overseas.

NOTE.—Detail will not necessarily add to totals because of rounding.
See Table B–20 for additional population data.

Source: Department of Commerce.

Rapid growth during the rest of this decade of persons in the 20–24 age group will contribute to the demand for multi-family dwellings, since these people are typically renters. Meanwhile, people in their late twenties will also be increasing in number, although less sharply, and will be starting to buy their own homes. Between 1970 and 1975, population developments should have a major impact on the demand for new housing as the 25–34 age group swells by almost 6 million persons, as shown in Table 11.

The typically high-saving group—persons aged 45–64—will grow only slowly, and its relative importance will decline throughout the 1965–75 decade. The number of persons over retirement age meanwhile will rise by one-sixth. Thus to some degree over the next five years and to a greater extent in the 1970's, population trends should contribute to a strong demand for residential construction and for consumer goods and services relative to total incomes.

Continued rapid expansion of actual output and job opportunities is required to translate this latent spending, suggested by population trends, into effective demands. With full employment still some distance away and with unemployment already high among younger workers, Government policies must continue to be expansionary and manpower policies must be diligently pursued so that jobs and incomes can be made fully available to these workers. If these people obtain jobs, their demands for goods and services will help to maintain full employment.

*Business fixed investment*

If the economy successfully meets the challenge of attaining and maintaining full employment, the stepped-up growth of the labor force will also have favorable effects on the strength of investment demand. With more men on the job, more tools would be needed to outfit them efficiently. If, over the next five years, two million additional private jobs are created to match the more rapid growth of the labor force, the economy would, on that account, require roughly $25 billion of extra capital. This would be a major addition to investment demand. On the other hand, if labor should be in excess supply—if the economy fails to attain full employment—the incentives for increasing capacity and economizing on labor would weaken.

Although more uncertain than the population trends, another factor that could stimulate investment in the coming decade is the speeding of technological innovation. Research and development expenditures have quadrupled in the last decade and are continuing to rise, although less rapidly.

The reservoir of commercially exploitable technology can be expected to increase during the remainder of the decade. New technical developments will spur businessmen to replace older equipment more rapidly and to purchase equipment capable of producing entirely new products. On the other hand, some innovations may make capital equipment more efficient and thus reduce the amount of investment needed to create any given amount of capacity.

In the early postwar years, business fixed investment (in 1964 prices) typically exceeded 11 percent of GNP. Since 1958 it has constituted only about 9 percent of our national output, and also a smaller fraction of gross retained earnings of corporations. For the remainder of this decade, investment is likely to contribute more strength to the economy than it did typically in the 1958–63 period, but it cannot be expected to match its early postwar performance, when heavy backlogs added to demand.

*Conclusion*

The bulk of evidence points to a moderate and gradual strengthening of underlying demand on the part of consumers and businesses. Expenditures for goods and services by State and local governments should also continue to serve as an expansionary force in the years ahead. Over the longer run, these developments may gradually alter the appropriate direction of fiscal and monetary policy. Over the next few years, private demand will need the support of expansionary Federal policies if we are to attain full employment and realize our more rapidly growing potential.

## POLICIES FOR PROSPERITY

Prosperity requires achieving and maintaining a balanced advance of demand and productive capacity. Notwithstanding the long historical record of periodic recessions or depressions, there is much evidence in economic analysis and in postwar experience, both here and abroad, that such a balance can be sustained.

Experience and logic also warn us, however, that balanced growth seldom sustains itself automatically. Fiscal and monetary policies must be continuously adjusted to keep the aggregate demand for goods and services in line with the economy's growing capacity to produce them. Flexible use of monetary and fiscal measures is one of the factors responsible for the steadiness of postwar economic progress in other industrial countries of the free world. It has also played an important role in our expansion since 1961.

The U.S. record of recent years is gratifying. But it would be much more gratifying if it had occurred with unemployment rates steadily in the neighborhood of 4 percent, and with industrial operating rates near the levels preferred by industry for maximum efficiency. The record gives us great reason to hope that the U.S. economy is capable of steady and balanced advance at more satisfactory rates of utilization of manpower and industrial capacity. The same wisdom and flexibility in public and private policies which have sustained this expansion could sustain growth at roughly the same pace but at a higher level. The manpower and other policies described in Chapter 3 would then have a particularly important role to play; combined with the price and wage policies described later in this chapter, they could assure that expansion would proceed at stable prices.

That unemployment has fallen only to 5 percent after four years of steady economic expansion is clear evidence of the immense and growing productivity of the American economy. Basically, this should be a cause for hope rather than for despair. But it takes adequate total demand, and adequately growing total demand, to harness this potential to the needs and wants of the American people.

### FISCAL POLICY TO SUSTAIN EXPANSION

Fiscal policy is the Federal Government's most powerful instrument for influencing total demand. Changes in Federal purchases of goods and services can have an important effect on over-all economic activity. Similarly, variations in Federal taxes and transfer payments have major influence on the flow of after-tax earnings to private spending units.

As discussed in Chapter 1, the full-employment surplus is a useful measure of the over-all impact of the Federal budget on economic activity. Changes in this surplus indicate whether the Federal budget is becoming more or less expansionary. When aggregate demand needs a stimulus in order to achieve full employment, it is appropriate to reduce the full-employment surplus. When a restrictive influence is called for, the full-employment surplus should be raised.

As our productive capacity grows through time, so do Federal tax revenues at full employment. Indeed, the percentage growth in Federal revenues tends to exceed slightly the growth in potential GNP. Consequently, if Federal tax rates are unchanged and expenditures grow less rapidly than potential output, the full-employment surplus tends to rise, restricting the expansion of total demand. When the economy is threatened with excessive demand, this restrictive influence is desirable. But it is not appropropriate when the economy is well below full employment. The need for fiscal measures to prevent undesired increases in the full-employment surplus also provides opportunities to pursue important national goals: by expanding or initiating vital Federal programs, by assistance to State and local governments, or by further tax reductions or increases in transfer payments to individuals.

*Uses of expanding revenues*

Many national needs will be met only if the Federal Government takes the lead. While increasing efficiency within the Government will serve to hold down the growth of budget expenditures, it is to be expected that Federal nonmilitary outlays will increase in 1965 and the years beyond. Some of these outlays will be public investments in physical capital and human resources. Grants are also likely to rise as the Federal Government assists State and local governments in strengthening public services that are best provided at the local level. Transfer payments will increase, as a compassionate society strives to aid the needy and to provide greater security for all its citizens. And a growing and more prosperous population will need and desire improved public services as part of a higher standard of living.

Tax reduction also offers attractive benefits. It provides opportunities for raising living standards through private consumption. Furthermore, lower income tax rates can strengthen the incentives to undertake risks, to work, and to exercise initiative. Thus tax cuts can invigorate markets and encourage the supply of new products and services through private enterprise.

*Choices and requirements of budget policy*

The allocation of our potential growth in revenues should reflect national priorities. To the extent that a democratic society desires to make additional resources available to meet pressing public needs and wants, increased Government outlays are called for. Alternatively, tax rate reductions give priority to private uses of resources. The criteria for this choice are not primarily economic. But economic analysis clearly indicates that, unless excess demand threatens, the Nation's fiscal dividend must be allocated between increased outlays and reduced taxes. Only in this way can fiscal policy promote sustained prosperity.

*Fiscal policies for other objectives*

Fiscal policies to achieve and maintain full employment must be shaped to permit simultaneous progress toward other economic objectives, including more rapid growth of potential output and improved international balance. Fortunately, fiscal policy is a versatile kit of tools. Through changes in the structure of taxes and the composition of public expenditures, it can contribute to these other goals.

The recent reductions in corporate tax rates, the investment tax credit, and depreciation reform, by increasing both financial resources and profitability, have stimulated investment and have contributed to the growth of potential output. The composition of public expenditures this year will put increased emphasis on education, which will improve the skills of the labor force and will speed technological advance. Federal expenditures for resource development, transportation, and research will open up profitable new investment opportunities for private enterprise. Such fiscal steps to raise the rate of growth are particularly important in periods when downward adjustments of interest rates are limited.

Similarly, financial measures directly affecting the international area, such as changes in the tax treatment of foreign earnings enacted in 1962 and proposed measures to improve the tax treatment of foreign portfolio investment in the United States, can influence capital flows and hence the balance of payments. Finally, special taxes, such as the Interest Equalization Tax, can be appropriately used under some conditions. Such special taxes cannot be properly considered basic elements of long-run policy, since they qualify the freedom of international trade and capital movements. In particular circumstances, however, they can be the least costly and least disruptive way of dealing with temporary pressures.

*Current fiscal program*

With the economy currently below full-employment levels, continued rapid expansion of output is called for in 1965. Federal budgetary policy has been designed with this need in mind. Past fiscal measures lowering individual and corporate taxes will continue to strengthen the economy this year. The income tax cut will reach its full effect on consumer demand and have added influence on investment. In addition, new fiscal actions to sustain the expansion of the economy are set forth in the President's proposed budget.

In accordance with the Revenue Act of 1964, tax rates on 1965 incomes will be lower than those last year. Most of the tax cut's direct effect on disposable income, however, was experienced beginning in March 1964 when the withholding rate fell from 18 percent to 14 percent. This year, taxpayers will benefit from twelve rather than ten months of lower withholding, but the withholding rate will be unchanged. Hence, the "second stage" of the personal income tax cut will provide very little fresh stimulus. Indeed, when final settlements of 1964 taxes are made this spring, tax refunds will be reduced by more than $1 billion from last year's level, because the withholding rate was lowered in 1964. Nevertheless, the consumption-increasing effects of the original gain in disposable income have not as yet been fully realized. Expenditures out of the initial gain in income, in turn, lead to higher income in a continuing, but diminishing, chain. The time lags in this process are such that as much as one-fourth of the full annual consumption effect of the tax cut—or a gain of $5 billion—remains to be felt during 1965.

Favorable repercussions on investment should also continue. With the stimulus of improved operating rates, higher before-tax profits, and lower corporate taxes, business fixed investment rose strongly during 1964. Since even more substantial lags exist in investment spending, and since corporate profit tax rates are reduced by another 2 percentage points in 1965, tax reductions are continuing to strengthen fixed capital outlays.

*Fiscal 1966 budget*

In addition to the stimulating effects of past fiscal policies, the President's budget program for fiscal 1966 calls for several new expansionary actions. First, an excise tax reduction of $1¾ billion is proposed to take effect on July 1, 1965.

After substantial recent reductions in corporate and in individual income taxes, it is appropriate to direct further tax relief at excises this year. Present excises were imposed, in many instances, as wartime emergency measures. In some instances, their collection is cumbersome and inefficient. Purchases of taxed products by low-income families may result in these families paying a higher tax in relation to their income than is paid by other consumers. Finally, excises may affect relative prices in a manner that reflects neither costs of production nor social judgments, except in cases where they serve in lieu of "user charges," such as the gasoline tax earmarked for highways, or where they result from a deliberate social decision to restrain the consumption of certain products, such as liquor and tobacco.

Excise tax cuts will raise the real purchasing power of disposable incomes, provided that they are passed on to consumers in lower prices, and this gain will produce essentially the same chain of effects as income tax reduction. But price reduction is vital to the full effectiveness of excise reduction. If prices do not fall, the resulting gain will be in profits rather than in consumer income. Half of the gain in corporate profits would be returned to the Government in higher profit taxes, thus cutting the effective excise tax reduction by one-half. The remainder would offer no direct stimulus to consumer demand and would provide at best a weak and inefficient incentive to investment. Prompt price reductions for the affected products are of crucial importance and can be expected to be brought about by competitive forces.

A second expansionary influence for 1965 is the proposed social insurance legislation. Liberalization in social security benefits amounting to more than $1¼ billion a year is to be enacted by midyear and will be effective retroactively to January 1, 1965. For the sound long-run financing of the social security trust funds, a rise in payroll tax rates and a revision in the tax base are scheduled for January 1, 1966.

Finally, Federal outlays (as shown in the national income and product accounts) will rise in 1965 by $3½ billion over and above the social insurance liberalization. Most of the increase will be in the form of larger transfer payments and grants-in-aid to State and local governments, rather than purchases of goods and services; and much of the increase will occur in the trust funds rather than in the administrative budget. Some new and expanded activities—many of which are discussed in the following chapters—are provided for in the budget; their cost is partly offset by economies in less urgently needed programs.

The excise tax cut and social insurance liberalization will stimulate consumer spending in the second half of this year. The expansionary actions in the President's program will more than offset the full-employment growth of Federal revenues and thus will reduce the full-employment surplus during 1965. The full-employment surplus is scheduled to increase in the first half of 1966 because of the rise in payroll taxes. Therefore, the rate of economic advance in the next eighteen months will reflect, to an increasing degree, the strength of private demand. The record of this period should test the economy's ability to advance in high gear with a small, but no longer declining, full-employment surplus.

The response of the economy to this test could call for revisions in budget policy. If private demand should show signs of cumulative weakness, it would be appropriate to provide new fiscal stimulus. Alternatively, if private demand should strengthen markedly and threaten to strain productive capacity, fiscal and monetary policies should be shifted in a restrictive direction.

Policies can respond to unanticipated developments as they emerge. But they would be faced by a dilemma if price-wage pressures were to threaten our record of price stability while the economy remained below full employment. Under such circumstances, restrictive measures might offer a weak antidote to inflation by making the environment less favorable for price increases; but at the same time these policies could have a sharply adverse effect on employment and could impair the productivity gains that permit higher wage rates within a framework of constant unit labor costs.

Flexibility in fiscal policy is especially important when the economy is suddenly threatened with recession. Continuing policies to strengthen expansion supply a solid first line of protection against recurrent recession. But imbalances can develop in a free enterprise economy, and can trigger costly and cumulative downturns in business activity. Automatic fiscal stabilizers help to cushion the economy in a period of declining activity. But they must be supplemented by strong and prompt discretionary fiscal actions if we are to minimize the severity of recessions.

Flexible use of fiscal policy requires cooperative efforts by the Administration, the Congress, and the public. The Administration is determined to recognize the problem candidly and to take decisive action promptly when economic activity is faltering. The Congress contributes by being prepared to consider the President's proposals with all possible speed. The public—consumers, business, and labor—can be expected to regard constructive Government policies to combat recession as a source of strength rather than as a reflection of weakness. The bright prospects for continued expansion this year offer an opportunity to review the available means for such cooperative action, so that our defenses will be strong when and if they are tested in the future.

### *Costs of Recessions*

Even minor recessions have huge costs. In the postwar period, the United States has successfully avoided a recurrence of the seriously depressed conditions of the 1930's, but it has experienced four recessions which caused personal hardship for millions of Americans. During the course of these recessions, on average, real GNP fell by more than 3 percent; the unemployment rate rose by 2 percentage points; and corporate profits fell by more than 25 percent. In the years most heavily scarred by recession, the number of people unemployed long enough to exhaust their unemployment compensation benefits rose by 840,000; the number of families with incomes below the $3,000 poverty line rose by 400,000; and the number of families receiving general assistance payments rose by 70,000.

### *Automatic Stabilizers*

These recessions would have been far more costly had it not been for the "built-in" fiscal stabilizers of our modern economy. During recession, Government purchases resist the decline in private outlays. Moreover, Government transfer payments rise as unemployment increases; and tax collections fall as corporate profits and wages decline. Thus, the Federal tax-transfer system automatically draws less purchasing power out of the private sector.

In postwar recessions, built-in stabilizers have worked primarily through changes in corporate profits, the corporate tax yield, and transfer payments.

The 1960–61 recession can serve as an illustration. During that recession, national income fell by $4.5 billion (annual rate), but personal income actually rose by $5.2 billion. Corporate profits bore the brunt of the decline, but reductions in corporation tax liabilities helped to maintain dividends. Increased transfer payments, including a $1.4 billion (annual rate) rise in unemployment benefits, offset some losses in earnings.

Strengthening the unemployment compensation system deserves high priority among possible steps to increase the automatic resistance of the economy to recessions. The most important reasons for improving the system are to increase individual security and reduce the unnecessary human costs of unemployment. But a strengthened system would also sustain consumer purchasing power more effectively, thereby reducing the amount of unemployment as well.

At present, the unemployment insurance system excludes about one-fifth of all workers; a particularly unfortunate omission is employees of small firms who are by no means immune to unemployment. Furthermore, average benefits presently amount to only about 35 percent of average wages in covered employment; in 1939, the average benefit was more than 40 percent of average covered wages. Finally, with the present maximum duration of benefit payments, a particularly large number of recipients exhaust their benefits during a recession period before new employment opportunities develop. During 1961, about 2.4 million workers exhausted benefits despite the relatively rapid upturn in business activity from the 1960–61 recession. A series of Administration proposals for strengthening the unemployment compensation system is being sent to Congress this year.

*Discretionary Actions on Taxes and Expenditures*

Although automatic stabilizers do much to moderate recessions, they cannot be relied on either to prevent them or to turn the tide. Federal taxing and spending measures that reduce the full-employment surplus can, however, be effective in reversing recession.

As the President has stated, ". . . *if* recession were to threaten, a well-timed tax cut would be one of our most effective measures." Therefore, he is asking Congress to consider how a temporary income tax reduction can be "well-timed" to combat recession. The President is suggesting that Congress itself evaluate its procedures and determine the best way to reinforce the Nation's confidence that an anti-recession tax proposal would be considered and voted on promptly.

Accelerated Government spending can also provide powerful assistance to the economy if recession should threaten. As noted in Chapter 1, rapid increases in Federal outlays were called for in 1961 to strengthen national security; these outlays also helped to spur recovery from the recession. In the future, we cannot count on new public expenditure requirements to develop just at the time of recession. Nevertheless, there are many continuing public needs which provide opportunities for expanding Federal outlays if additional fiscal stimulus becomes appropriate. These opportunities must be grasped promptly if they are to have maximum effectiveness. Yet such increases in spending should not commit the Government to a higher level of outlays than would otherwise be desirable, once the economy recovered.

Advance planning makes possible a careful selection of those expenditure programs which could be most efficiently and most rapidly expanded in time of recession and contracted after recovery. This would assure that agencies have workable anti-recession plans on hand, permitting speedier action by the Administration and Congress and improving the efficiency of stepped-up expenditures.

The anti-recession possibilities of a wide range of Federal programs will be reviewed by the Administration this year. Certain maintenance, rehabilitation, and modernization activities on Federal facilities, or on State and local facilities assisted by Federal grants, provide opportunities to push funds rapidly through already existing "pipelines." Unlike certain traditional public works, many of these activities could be expanded readily, employing workers without previous similar job experience and not requiring commitment to a long-term program. Various training and community service programs might also be intensified appropriately, since the poverty-stricken and the unskilled are doubly disadvantaged in times of slack economic activity.

*Benefits of timely anti-recession actions*

If action could be taken in time, either temporary tax cuts or the acceleration of selected Government programs—or the two in combination—potentially have the speed and power to repel recessions. The time patterns of the postwar recessions of 1953–54, 1957–58, and 1960–61 illustrate the possible benefits of quick action after a downturn has been diagnosed. In 1953, evidence of weakening in the economy was available by June and the forces of recession were evident by September. Symptoms of the 1958 recession were clear by November 1957; in 1960, the downturn in the economy was widely recognized by September. A tax reduction, enacted within the first quarter after recession became apparent, would have provided a substantial lift to consumer spending in the following quarter. This boost might have converted the last months of decline into the initial months of recovery. The major expansionary effect of the tax cut would then have strengthened the advance over the next few quarters.

The need for stimulation does not disappear as soon as the economy turns up. Indeed, many policy actions in the past have been designed to strengthen the early stages of recovery. Even with such measures, the unemployment rate was 6.4 percent three quarters after the 1958 trough and still 5.8 percent in the following quarter. In 1961–62, the comparable unemployment readings were 6.2 percent and 5.6 percent.

Thus, in recent recessions, had prompt expansionary action been possible, it could have limited the drop in output and employment, might well have shortened the duration of the decline, and would clearly have strengthened recovery.

A future recession might differ from its postwar predecessors. There is no definite assurance that a future downturn would be recognizable—or would be recognized—as rapidly. On the other hand, neither can we be sure that the decline would—in the absence of policy—be as short and as shallow. The best possible guarantee against a severe recession is corrective action taken promptly, before depressive effects can cumulate and reinforce themselves.

Furthermore, it may actually be possible in some instances to prevent recessions before a downturn appears. If the economy seemed poised on the brink of a downturn, and excess capacity and ample labor supplies were available, prudence would call for prompt expansionary steps, which might head off recession altogether. Under such circumstances, prompt measures would be appropriate even if future demands proved somewhat stronger than expected.

*Summary*

Both our increasing appreciation of the effectiveness of fiscal policy, and the continual improvement in the detail, accuracy, and timeliness of our economic information, strengthen the conviction that recessions can be increasingly avoided and ultimately wiped out.

Policies designed to maintain continued healthy expansion—through tailoring the expected growth of total demand to the expected growth of productive capacity—should lessen the chance that imbalances might arise which could touch off recessions. But unexpected events and miscalculations will still occur. When this happens, we must be prepared to act promptly. It will be easier to deal with recessionary tendencies, and in some cases even avert an impending downturn, if the Congress is ready to act quickly on requests for temporary tax cuts and if expenditure programs are ready for prompt submission to the Congress. This readiness would provide a strong and comprehensive insurance policy, backing up the continuous application of fiscal and monetary policies to sustain prosperity.

## ROLE OF MONETARY POLICY

The degree to which fiscal policy should be stimulative or restrictive depends in part upon the monetary policies being pursued at the same time. Just as tax reduction stimulates private spending, so the ready availability of credit contributes to increased private outlays. In particular, spending for major durable goods—new housing, business plant and equipment, automobiles, and major household goods—is likely to depend in part upon the availability of credit and its cost. In an economy characterized by idle resources, expansionary monetary policy is desirable. It helps to strengthen private demand; at the same time, it contributes to the growth of productivity by encouraging investment for the purpose of developing and marketing new products and adopting up-to-date production techniques.

*Growth of liquid assets*

Over the long run, growth of economic activity must be supported by the continued expansion of monetary assets, since individuals and businesses need a growing volume of liquid balances for transaction purposes as their income and spending increase. The need for growth in liquid assets also results from investors' desires to hold some part of their wealth in assets that are readily accessible and free of risk.

Liquid assets can take a variety of forms, and new institutions are continually evolving to meet these needs. During the past thirty years, savings and loan associations and mutual savings banks have come to play an important role as competitors with commercial banks for the time and savings deposits of the public. Similarly, business firms frequently invest short-term funds in Treasury bills and in a wide and growing variety of other "money market" paper. Nevertheless, monetary assets provided by the commercial banking system continue to play a crucial role, since checks drawn on demand deposits constitute the most important medium of exchange for transacting day-to-day business. The growth of liquid assets, and particularly of the money supply, should keep pace with expanding requirements over the long run in order to support growth and economic advance.

*Monetary expansion and gold reserves*

As demand deposits and time and savings accounts at commercial banks expand over time, these banks are required to hold a growing volume of reserves which are largely deposited with the Federal Reserve System. Under current law, the Federal Reserve is required to hold gold certificates equaling at least 25 percent of the total of its deposits and outstanding notes, which constitute the major part of our currency. At the turn of the year, the gold holdings of the Federal Reserve amounted to about 28 percent of its liabilities in the form of deposits and notes. Apart from any changes in the U.S. gold stock, the provisions of current law would shortly circumscribe our freedom of action in achieving needed growth in our money supply. Although the Federal Reserve has the authority to waive the gold cover requirement, such a temporary expedient would not be a satisfactory response to a long-range need.

Monetary policy is formulated by responsible officials with a view to the public interest, and the presence of a mechanical limit on monetary expansion is inappropriate. Such a limit is either irrelevant—when the gold stock is far above the legal minimum—or harmful—when the gold stock acts as an arbitrary restraint. Consequently, the President has proposed that the Federal Reserve Act be amended to require gold cover only for Federal Reserve notes and not for deposits in Federal Reserve Banks. This will assure continued opportunity for monetary growth and for needed flexibility in the operation of monetary policy. In addition, it will emphasize the full availability of our gold stock, at its fixed price of $35 an ounce, to defend the dollar in international markets.

*Limitations and opportunities for monetary policy*

Monetary policy must serve both the domestic objectives of full employment and more rapid growth and the international objective of balance of payments equilibrium in the framework of a stronger international trade and payments system. Greater availability and lower costs of credit and liquidity help to stimulate total demand and economic growth. However, if U.S. interest rates—particularly short-term rates—were permitted to fall significantly below those in other international financial centers, domestic funds would tend to flow abroad in search of higher yields. Thus, the freedom of expansionary monetary action is necessarily limited when the Nation is determined to correct a balance of payments problem.

The constraints on the use of monetary policy for domestic purposes are related to the particular circumstances of the United States in recent years. Over the longer run, it may well be possible to increase the freedom of monetary policy. As the fabric of international cooperation is strengthened by continuing consultation, in such forums as the Organization for Economic Cooperation and Development (OECD), it should be possible to deal more fully with issues involving the interdependence of countries in setting their national economic policies. One important question is whether most of the world would be better off domestically—and no worse off internationally—if the industrial nations as a group had somewhat lower interest rates (offset in some countries by more restrictive fiscal policies).

This question may become particularly relevant in 1965, when the success of anti-inflation programs in some European countries, together with a slowdown in their domestic expansion, may encourage them to shift to a more expansionary policy. Some European countries are considering tax reductions for this purpose; an easier monetary policy and lower interest rates might be equally effective and could contribute to a better international structure of interest rates.

Despite the present international constraint, flexible use of the full range of instruments of monetary policy can continue to support domestic expansion. A combination of adjustments in maximum interest rates on deposits, open market operations in a wide range of securities, and changes in bank reserve requirements have been used in recent years to help to reconcile domestic and international objectives.

Through continued ingenuity in the choice of techniques, monetary and debt management policies in 1965 can meet international requirements and, at the same time, provide readily available credit to meet the needs of a noninflationary expansion. Thus, while fiscal policy must once again be the main contributor to the growth of demand, it can be supported by monetary policy.

## WAGES, COSTS, AND PRICES

Maintaining essential price stability in 1965 must be a national objective of high priority. The record of price stability in recent years has made possible a substantial improvement in our ability to compete in world markets. This record has also contributed to a balanced advance and has kept fiscal and monetary policies free to be expansionary. Furthermore, price stability has promoted equity by preserving the purchasing power of people with fixed incomes and liquid assets.

We have not yet succeeded in reaching our employment goals in this environment of stable prices. The ability to reconcile full employment and price stability will have a major influence on our long-term ability to grow, to maintain a leading position in the world, and to build a better life for all Americans. Now, with improved prosperity and reduced margins of idleness, our institutional arrangements for setting prices and wages face a stiffer test in avoiding tendencies toward inflation.

Our institutions are adapted to modern technology, which, in many industries, requires an enormous scale of operation and huge investment in productive facilities and distribution systems. The resulting large firms necessarily possess substantial market power, and may be in a position to raise prices even when demand does not exceed supply. Still, the discipline of competition is always at hand. Competition from abroad often challenges industries with heavy domestic concentration. Competition between industries selling substitutable products reinforces competition within industries. And antitrust enforcement helps to promote competitive behavior. Thus, the pricing process reflects both the exercise of discretionary market power and the influence of impersonal market forces.

In labor markets, unions have been formed to allow workers to bargain on equal terms with these large firms. Many unions have become powerful, and they are in a position to hold their own in the periodic collective bargaining process. Although they are constrained by market forces, powerful unions can, and sometimes do, obtain wage increases that outrun productivity even when labor supply is relatively abundant.

Because flexible and competitive market forces are not alone in affecting prices and wages, a modern economy needs new policies to reconcile the objectives of full employment and stable prices.

In one way or another virtually every advanced country has devised policies aimed at this reconciliation. Several nations have pursued such policies for many years. In December 1964, the United Kingdom launched a major new venture aimed at the cost problems which have contributed so much to her economic difficulties: leaders of business and labor signed a declaration of intent to pursue price, wage, production, and employment policies that will result in over-all price stability and an improved competitive position.

Because of differences among nations in political and economic systems, each country must find a solution appropriate to its own institutions. The U.S. economy is larger than the others and, as a result, many of our industries, including heavy industries requiring large scales of operation, are more competitive than in Western Europe or Japan. Major discretionary market power is found less frequently here, but it is found in important industries which have a wide and pervasive influence on prices and wages elsewhere through emulation and direct cost-push.

*Price-wage guideposts*

To deal with the problem of reconciliation—achieving noninflationary price and wage behavior under prosperous conditions—the Council's Annual Report in 1962 advanced the guideposts which were endorsed by President Kennedy and have been firmly restated by President Johnson.

The basic guideposts are simple and straightforward and contain an inescapable economic logic.

1. *The general guide for wages is that the percentage increase in total employee compensation per man-hour be equal to the national trend rate of increase in output per man-hour.*

If each industry follows this guidepost, unit labor costs in the over-all economy will maintain a constant average.

2. *The general guide for prices calls for stable prices in industries enjoying the same productivity growth as the average for the economy; rising prices in industries with smaller than average productivity gains; and declining prices in industries with greater than average productivity gains.*

If each industry follows this guidepost, prices in the economy will maintain a constant average.

Some exceptions to these guideposts are necessary to promote an efficient allocation of resources and a high rate of growth, and to redress inequities which have kept certain workers at the bottom of the wage scale. Wage increases above the guidepost level may be necessary where an industry is unable to attract sufficient labor to meet the demands for its products, where wages are particularly low, and where changes in work rules create large gains in productivity and substantial human costs requiring special adjustment of compensation. Because the industries in which market power is concentrated are largely high-wage industries with a relatively low long-term rate of increase of employment, the first two of these exceptions are rarely applicable.

On the price side, increases in price above the guidepost may be necessary to allow for increases in nonlabor costs or to correct an inability to attract needed capital.

Each of these exceptions has a symmetrical counterpart calling for downward departures from the guideposts. Wages should rise less than the guidepost rate where an industry suffers from above-average unemployment and where wages are exceptionally high for the type of work. Price increases should be smaller—or price decreases larger—where unit nonlabor costs fall, where capacity is too large, and where profits are based on excessive market power.

The guideposts are not meant to preclude the possibility of a change in distribution of income between labor and capital in industry. Where one side or the other is able to increase its share of industry income, but not at the expense of the public, the national interest need not be involved. However, it should be kept in mind that in most concentrated industries the division of income between labor and capital remained essentially unchanged all through the wage-price spirals of the 1950's. The repeated attempts to alter income shares proved self-defeating: neither side gained, and both lost through higher prices, weaker markets, reduced profits, and lower employment.

Table 12 illustrates the postwar experience with prices, wages, and productivity in the United States. Recent changes in employee compensation have conformed to productivity gains much more closely than in the 1950's, and price increases have been much more modest.

The guideposts offer a standard for responsible business, labor, and Government leadership in an environment of informed public opinion. They are an attempt to operate our economy as it is—without controls, without wholesale fragmentation of our large, successful enterprises—and to maintain stable prices while using our resources, our capital, and our labor to their full potential. They are in the tradition of America, asking those to whom the society has entrusted economic power to exercise it in ways consistent with the national interest.

TABLE 12.—*Changes in productivity, wages, and prices in the private economy since 1947*

| Year | Productivity [1] | Trend productivity [2] | Total compensation per man-hour | Prices | | |
|---|---|---|---|---|---|---|
| | | | | Implicit GNP deflator | Wholesale | Consumer |
| | Percentage change [3] | | | | | |
| 1948 | 3.6 | | 8.6 | 6.8 | 8.3 | 7.7 |
| 1949 | 2.8 | | 2.5 | −.8 | −5.0 | −1.0 |
| 1950 | 7.1 | | 5.7 | 1.2 | 4.0 | 1.0 |
| 1951 | 2.5 | | 9.3 | 7.9 | 11.4 | 8.0 |
| 1952 | 2.2 | 3.7 | 5.9 | 1.6 | −2.8 | 2.2 |
| 1953 | 4.0 | 3.7 | 5.8 | .6 | −1.4 | .8 |
| 1954 | 1.8 | 3.5 | 3.3 | .8 | .2 | .4 |
| 1955 | 4.4 | 3.0 | 2.9 | .9 | .3 | −.3 |
| 1956 | .2 | 2.5 | 6.1 | 3.1 | 3.2 | 1.5 |
| 1957 | 3.5 | 2.8 | 5.9 | 3.5 | 2.9 | 3.5 |
| 1958 | 2.4 | 2.5 | 3.6 | 1.7 | 1.4 | 2.8 |
| 1959 | 3.6 | 2.8 | 4.6 | 1.6 | .2 | .8 |
| 1960 | 2.0 | 2.3 | 3.6 | 1.2 | .1 | 1.6 |
| 1961 | 3.4 | 3.0 | 3.6 | 1.0 | −.4 | 1.1 |
| 1962 | 4.5 | 3.2 | 4.0 | .7 | .3 | 1.2 |
| 1963 | 2.9 | 3.3 | 3.1 | 1.2 | −.3 | 1.2 |
| 1964 | 3.1 | 3.2 | 3.8 | 1.4 | .2 | 1.3 |

[1] Output per man-hour for all persons; labor input based primarily on establishment data.
[2] Average annual percentage change in output per man-hour during latest five years.
[3] Percentage change from previous year, except trend productivity.

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

Large corporations and labor unions can—and generally do—use their power to play a constructive role in our economy. At the same time they must be accountable for their actions to public opinion, and must recognize that the public will ask "Why?"

—when a union insists on a wage settlement that, if universally applied, would mar the price record of the economy;

—when a firm or industry agrees willingly to a wage settlement above the guideposts which it then translates into higher prices for its products;

—when a firm or industry with extraordinary productivity gains fails to share the benefits with consumers in the form of lower prices;

—when a firm or industry with average productivity gains chooses to raise its prices.

## INTERNATIONAL ECONOMIC POLICIES

The formulation of domestic economic policies must take account of the impact of these policies on the economies of other countries and on our international relations. A strong U.S. economy promotes growth and prosperity abroad. At the same time, a vigorous and growing world economy and expanding world trade contribute to our own growth, stability, and vitality.

High among immediate U.S. priorities is the necessity for further strengthening of our international payments position. While devoting special attention to balance of payments problems, we will also continue to work actively toward the attainment of longer-range international economic goals: liberalizing the world's trading arrangements; strengthening the economies of the less developed countries; and further improving international monetary arrangements.

In all of these areas, important progress has been made in the recent past, but major tasks remain. This section outlines near-term and longer-run policies for carrying out these tasks.

### BALANCE OF PAYMENTS: PROSPECTS AND POLICIES

The U.S. payments position showed further improvement between 1963 and 1964 while the economy was registering major gains in income and employment. But even more substantial reductions in the payments deficit must remain among the key objectives of national economic policy.

#### *Longer-run prospects*

Evidence accumulated during the past year generally confirms the conclusion of last year's Annual Report of the Council that the longer-term prospects for continued improvement in the U.S. payments position are favorable.

With domestic prices remaining essentially stable, it should be possible to consolidate and extend the recent improvement in the competitiveness of our exports. Moreover, exports will be aided in coming years by continued strong growth of incomes abroad. Demands for labor-saving investment goods—in the development and production of which the United States has traditionally pioneered—should increase. The stronger position of primary producing countries, furthermore, may continue to add significantly to these countries' demands for American products.

Income from past investments abroad should continue to rise rapidly. Further progress is also being made in the reduction of the balance of payments cost of military and other government transactions overseas. At the same time, however, our persistent deficit on tourist account will continue to reflect rising incomes at home and growing interest in foreign lands. U.S. imports, too, will grow as our economy expands. But it is encouraging that the growth of U.S. imports in recent years has been somewhat smaller than might have been expected on the basis of experience in earlier periods of economic expansion. This apparently reflects, in part, the improved competitiveness of American products.

The future course of U.S. direct investment abroad will be influenced by conflicting forces. Sustained prosperity in the United States may encourage investment at home rather than abroad. An increasingly less receptive attitude on the part of a number of foreign countries toward an expansion of American ownership may deter direct investment. At the same time, however, American firms still have strong incentives to expand their facilities or open new ones in widening foreign markets, particularly the European Economic Community (EEC).

New issues of foreign securities in the U.S. market, as already noted, were restrained by the Interest Equalization Tax in 1964. Revisions that are being recommended in the U.S. tax treatment of earnings of foreign investors in the United States should encourage increased purchases of U.S. securities. Current efforts to improve and enlarge capital markets abroad should also bear fruit over the longer run, although foreign demands on U.S. capital markets are likely to remain substantial for some time to come.

*Problems and policies*

While the analysis of key factors underlying our basic payments position leads to a favorable over-all appraisal, there are various uncertainties in the more immediate future that are cause for concern. The very large gains in our trade balance recorded since early 1963, for example, may be difficult to repeat. Moreover, the factors mentioned earlier which gave rise to exceptionally large capital outflow in late 1964, while expected to have less force in coming months, might tend to delay satisfactory progress toward balance in our international accounts. Thus, the Administration is currently undertaking an intensive assessment of our near-term balance of payments prospects and their implications for policy. The results of this assessment will be the subject of a special Presidential message in the near future.

It is clear that continued U.S. success in maintaining cost-price stability associated with rapid gains in productivity is fundamental to improvement in our balance of payments. Also required are sustained efforts to promote American exports and to encourage tourism within the United States by both Americans and foreigners. And, for the time being at least, we cannot relax the various special measures now in force, such as the tying of foreign aid, which are designed to keep the balance of payments cost of U.S. Government expenditures abroad at the lowest practical level consistent with our foreign policy and national security objectives.

With the help of appropriate policies, we must move decisively toward international balance, thereby reinforcing the position of the dollar as the world's major reserve currency. As we succeed in this endeavor, we can expect to encounter some demand by both private and official foreign holders for additional short-term dollar assets needed to help to meet their growing liquidity requirements. Under such circumstances, the United States can reasonably supply a limited volume of additional dollars in keeping with the ultimate objective of equilibrium in its payments position.

Two broad principles will continue to govern our choice of policies. First, policies directed at the balance of payments must remain coordinated with our over-all national economic policies. Second, truly effective measures to strengthen the balance of payments of any major trading and investing nation—especially a key-currency country—cannot be devised by individual countries in isolation. The burdens and benefits of adjustment must be shared by deficit and surplus countries. Indeed, further progress toward reasonable balance of payments equilibrium among all countries requires close cooperation among economic policy-makers here and abroad.

## TRADE

The growth of world trade is strongly influenced by the commercial policies which trading nations pursue, individually and collectively. The reduction or elimination of barriers to trade and measures for its further expansion were intensively discussed in two major international forums during the past year—the General Agreement on Tariffs and Trade (GATT) and the United Nations Conference on Trade and Development.

### *Kennedy Round*

The Kennedy Round of trade negotiations opened formally in Geneva last May and got under way in earnest toward the end of the year. The objectives of the United States, whose participation in these negotiations was made possible by the Trade Expansion Act of 1962, are a 50 percent cut in tariffs on as wide a range of industrial products as possible, the substantial liberalization of trade in agricultural products, the reduction or removal of nontariff barriers to trade, and the opening of greater trade opportunities to the less developed countries.

The working hypothesis adopted by the GATT nations is to apply 50 percent tariff reductions across the board to industrial products which are not specifically excluded by the participating countries. In November, after many months of intensive preparatory work, the major trading nations submitted their "exceptions lists," identifying the products which they wished to withhold from all or part of the 50 percent tariff cut. Successfully passing this major milestone implicitly reaffirmed the commitment of the major trading nations to a substantial lowering of tariff barriers.

Progress has been slower in the negotiations on agriculture. The United States has insisted from the start of the preparatory discussions that agricultural products, as well as industrial products, must be included in the forthcoming negotiations. From the standpoint of both its own interest and that of the world trading community, the United States is concerned lest, in the process of eliminating intra-EEC barriers on trade in agricultural products, the EEC countries erect new external restrictions. It is important that further development of the EEC contribute to the growth of over-all world trade as well as to the expansion of commerce within the Community. The United States remains eager to negotiate tariff and other trade concessions with the EEC countries which will cover agriculture as well as industry. Our objective is to achieve meaningful tariff concessions that will expand world trade.

According to the principles laid down by the GATT Ministers, the less developed countries are not expected to offer full reciprocity for the concessions extended to them by the developed countries. These countries will stand to benefit from the elimination of tariffs on tropical products and also to some extent from the reductions in tariffs on industrial products and the liberalization of agricultural trade.

As 1965 opens, the United States looks forward to successful negotiations in the Kennedy Round. These negotiations, expected to run through the current year and perhaps into 1966, will be complex and difficult, for the stakes are high—involving as they do the vital interests of 40 or more participating nations. Success will stimulate trade expansion and closer economic cooperation, stepping up worldwide productive capacity and efficiency and contributing to rising incomes and greater human welfare in all countries; failure would risk the onset of a new wave of protectionism.

The years immediately ahead may be among the most dramatic and rewarding in our continuing drive for trade liberalization begun thirty years ago.

*UN Conference on Trade and Development*

The United Nations Conference on Trade and Development (UNCTAD) provided a forum primarily for the less developed countries to express their views on the present legal and institutional framework governing world trade, and to make a series of suggestions for trade policies to promote economic development. The Conference was the first of its kind, and revealed a striking unity among 77 less developed countries in urging changes in the existing order. Permanent machinery—a Trade and Development Board—has been established under the United Nations for the continuing study of related trade and development problems. The UNCTAD participants also agreed to hold a similar formal conference in 1966, and every three years thereafter. In the meantime, the United States and other advanced countries are engaged in a major reexamination of their individual and collective economic policies toward the less developed countries.

The UNCTAD focused attention on many trade and development issues of particular interest to the developing countries. Recommendations adopted by the Conference without dissent dealt, among other things, with the removal of obstacles to the expansion of developing countries' exports; the promotion of trade among developing countries; studies of means to provide additional compensatory and supplementary financing to offset short- and long-term losses of export earnings; and a study of an interest equalization fund to encourage the use of previously untapped international financial resources.

The proposal that developed countries grant generalized tariff preferences to the exports of manufactures and semimanufactures from developing countries was strongly pressed at the UNCTAD. The Conference was unable to agree on a positive recommendation regarding preferences, but the issue remains of primary concern to the developing countries and is receiving further study.

The United States has chosen to play a major role in the organization of post-UNCTAD activities. We are hopeful that these sessions will be profitable for all concerned, and that they will be used to advance the widely shared objective of a more rapid expansion of trade and economic development throughout the world.

## FOREIGN AID

U.S. foreign assistance policy is based on both humanitarian and national security considerations. It also is based on two premises regarding the development process: first, that external assistance plays a vital role in furthering economic growth, frequently providing the difference between satisfactory growth and stagnation; second, that such assistance can only complement efforts by the recipient nations in their own behalf.

In recent years the United States has increasingly concentrated its aid in those countries that have the best prospects for growth and that demonstrate a willingness and ability to help themselves, thereby ensuring that our assistance will make a maximum impact in promoting economic development. Such aid serves a variety of purposes: to help to broaden the capital base of developing countries; to facilitate the transfer of skills and knowledge through technical assistance; and, in some instances, to assist in the maintenance of the political and economic stability that is a prerequisite for economic growth.

In Latin America, our development loans and technical assistance are channeled through the Alliance for Progress as part of a broad cooperative effort by the nations of the Western Hemisphere. Outside the Western Hemisphere, major recipients of U.S. development assistance include India, Pakistan, Turkey, and Nigeria. In those countries still faced by immediate threats to their security, military assistance—amounting to more than one-fourth of total U.S. foreign aid—supports local defense forces, thus freeing a portion of the recipients' domestic resources for development purposes.

In the years ahead, gross aid disbursements must continue to rise if the current momentum of economic development of the poorer nations is to be maintained and accelerated. Consequently, the United States is pressing for greater aid contributions from those advanced countries that can clearly afford larger programs, as well as for a general easing of the terms on aid loans, i.e., for lower interest rates and longer maturities. As the public and private external debt burdens of the less developed countries mount, the need for lengthening the maturity and grace periods of future loans becomes more urgent.

Private investment from developed countries is another and, in the long run, perhaps more important, potential source of capital—as well as of technical and managerial skills—for less developed countries. To stimulate greater U.S. private participation in economic development activities, the Agency for International Development (AID) offers U.S. businessmen a wide range of investment guarantees, local currency loans, and special services by AID Missions abroad. The Administration has also proposed an investment tax credit for U.S. firms investing in developing countries.

The United States is gradually eliminating AID assistance programs in a number of countries, such as Taiwan, where rising incomes and expanding investment opportunities are now attracting substantial and increasing domestic savings and relatively hard loans from abroad. In the near future, other nations can be expected to make the same transition, though, in still others, successful development may require larger imports of capital in the short run.

Successful and balanced growth in low-income areas is a complex evolution in which social, political, technical, and human change are all interwoven. Such growth cannot be attained instantaneously, but there have been solid accomplishments. In helping 75 countries to help themselves, we are engaged in an undertaking of indefinite duration but also of inestimable importance to the current and future economic and political health of the entire world.

## INTERNATIONAL MONETARY ARRANGEMENTS

During 1964, questions regarding the future of international monetary arrangements came to the forefront of public discussion. Two thorough studies of the present functioning and the future needs of the system were completed last August, one prepared by the Deputies of the Finance Ministers and Central Bank Governors of the leading industrial countries known as the "Group of Ten," the other by the staff of the International Monetary Fund (IMF). These formed the basis for a number of steps taken at the Annual Meeting of the Governors of the Fund that promise to improve the functioning of world monetary arrangements. The studies also led to frank and open discussions of those longer-run issues on which agreement had not yet been reached. The actual course of monetary developments during the year, moreover—notably those connected with the defense of the British pound against speculative attacks—helped to bring both the strength and the limitations of existing monetary arrangements into even sharper focus.

As the Council's Annual Report for 1964 pointed out, a properly functioning international monetary system should promote steady growth of the world economy. It should (a) minimize disruptive and speculative conversions of foreign exchange into gold and prevent such conversions from reducing international liquidity; (b) encourage adjustment of imbalances by both deficit and surplus countries in ways that avoid imparting either a deflationary or an inflationary bias to the world economy, and that foster greater freedom of international transactions; (c) make adequate but not excessive financial resources available to permit achievement of these objectives. The reports of the Group of Ten and the IMF examined present and prospective international monetary arrangements from each of these viewpoints.

*Areas of substantial agreement*

The two reports (which reached broadly similar conclusions) revealed a wide range of issues on which the financial authorities of the major industrial countries are in substantial agreement. No abrupt change in present institutional arrangements was considered either necessary or desirable. Thus, the report of the Group of Ten stressed that the existing international monetary system based on fixed exchange rates and the established price of gold has "proved its value as a foundation on which to build for the future." It also declared that *over-all* liquidity "seemed fully adequate under present circumstances to cope with possible threats to the stability of the international payments system." At the same time, it suggested that the growth of world trade and payments is likely to require larger liquidity in the future, involving further increases in credit facilities, and, in the longer run, "possibly" calling for some new form of reserve asset.

For the nearer term, there was substantial agreement that growing liquidity needs could largely be met by a further expansion of credit, reinforced by increasingly close cooperation among monetary and other financial authorities. The network of bilateral and multilateral credit facilities that has been built up in recent years—including reciprocal swap arrangements, *ad hoc* central bank support operations, and the issuance of special medium-term bonds to creditor countries for reserve purposes—has proved a flexible and highly effective instrument for expanding usable liquidity, particularly when needed as a defense against sudden speculative attacks. Further use of such devices was recommended, given proper safeguards. At the same time, stress was placed on the likelihood of enlarged future needs for the use of medium-term credits from the IMF. The two reports therefore recommended—and the Governors of the Fund subsequently directed—that consideration be given to a moderate general increase in Fund quotas (probably of about 25 percent) and to appropriate additional selective quota increases.

As a means of encouraging the economical and efficient use of gold, the Fund report favored the handling of new quota subscriptions so as to "mitigate the repercussions of gold payments on the gold reserves of the contributing members and of the reserve centers that may be affected." The report of the Group of Ten took a similar position. In the case of the United States, such mitigation would seek to limit reductions in U.S. gold holdings occasioned by the increase in IMF quotas to the amount of the United States' own gold contribution—a contribution that would carry with it an equivalent assured drawing right on the Fund. If, by contrast, other countries bought gold from the United States in order to make their contributions to the Fund, U.S. reserves and the total of world reserves would be reduced.

In discussing credit facilities, the reports also noted that there had as yet been little provision for long-term lending for monetary purposes. Some of the Deputies of the Group of Ten suggested, therefore, that in certain exceptional cases, countries with large and growing reserves might properly extend longer-term loans to other industrialized countries in need of additional reserves. Such long-term loans might in certain instances be in the general interest of all the industrial countries. Appropriate long-term adjustment by a low reserve country may be more effective when that country pursues a gradual return to payments surpluses than when it attempts an abrupt balance of payments improvement that requires severe deflationary measures and could disrupt international trade. Such long-term arrangements could be attractive to lenders, provided that the loan could be shifted to a country in a stronger reserve position if the reserve position of the original lender should decline substantially.

Any expansion of credit facilities, of course, also carries significant risks. Undue reliance on the use of such facilities may delay the initiation of corrective actions—on the part both of deficit and of surplus countries—that are appropriate to bring payments positions into better balance. Such risks are increased if insufficient information is available regarding the total volume of actual credit extensions.

To deal with such problems, and to provide a firmer basis for the further expansion of credit facilities, the Group of Ten agreed that bilateral financing and liquidity creation should be subject to "multilateral surveillance," to be conducted primarily under the auspices of the OECD. This will essentially involve a more regular and systematic exchange of information on the means of financing both deficits and surpluses. At the same time, the Group of Ten suggested intensive further study of the nature of the adjustment process in international payments and of the optimal "mix" of monetary, fiscal, incomes, trade, and other policies for the achievement of both internal and external objectives. Such a study—also under OECD auspices—is now under way.

*Some major questions remaining to be resolved*

Looking toward the possible future need for a new type of reserve asset to supplement gold and foreign exchange, the Group of Ten established a study group on the Creation of Reserve Assets. Broadly speaking, the study group was asked to examine and compare two general approaches. One approach would introduce a new reserve unit by formal decision of the member countries of the Group of Ten. While such a new unit could take a variety of forms, one proposal which has been put forward is for a collective reserve unit closely linked to gold in its creation and use.

A second major approach would be based on acceptance and further development of gold tranche and similar claims on the IMF as international reserve assets. There are several techniques by which the total of reserve assets in this form can be varied in accordance with economic and financial conditions as they affect the reserve needs of Fund members, particularly the industrial countries which account for the bulk of the movements in international reserves.

It is natural that the views of individual countries with respect to future arrangements should reflect their current positions and problems. Despite this divergence, there is probably general agreement that a system of reserve creation must avoid exposing surplus countries to inflationary pressures from an excess of liquidity in the hands of deficit countries. At the same time, procedures for reserve creation and international lending must be sufficiently flexible to permit payments imbalances to be corrected in a way that gives full recognition to the importance of economic growth and flourishing trade.

*Questions raised by more recent experience*

The defensive capabilities of the international monetary system were demonstrated late in 1964 by the decisive moves to counteract the sudden speculative attack on sterling. The ability and determination of the international financial authorities to mobilize needed resources on short notice provided impressive backing for the conclusions of the Group of Ten and IMF reports that existing arrangements are fully capable of coping with major speculative attacks.

Yet the events of 1964 underlined the fact that the international monetary system has further problems to solve. Foremost among these is the question of improving the balance of payments adjustment process through policies—pursued by both deficit and surplus countries—that are consistent with steady economic growth, reasonably stable prices, and freedom of international transactions. Some of the measures adopted in 1964 to deal with imbalances, though justified by circumstances, would clearly be inconsistent with basic objectives if maintained for long. We must continue to work toward the proper mix of facilities to finance imbalances and policies to correct them.

## Chapter 3

# Strengthening the Efficiency and Flexibility of the Economy

THE STRENGTH of the American economy reflects its characteristic adaptability to rapid change—its ability to generate new products and new technological processes, to replace old industries by new ones, and to absorb a vast influx of labor from varied backgrounds. The foundation of our economic system is the freedom of resources to find their best uses, facilitated by a system of flexible markets which channel savings to lenders, raw materials to industrial users, finished products to consumers, and labor and capital from industries of decline to those of growth.

Our markets have performed these functions well, but policy must work steadily to improve their effectiveness. With larger increases in the labor force now upon us and the skill requirements of jobs rising, flexibility of our labor markets is being put to severe tests. For over seventy years, the Federal Government has accepted responsibility for sustaining a competitive economy. This job is never finished. The competitive structure of industry and the operation of markets for its products need continually to be strengthened. Government has increased the scope of its activities, making efficiency in its use of resources more important than ever before.

Several of the most important policy advances of the last few years serve to improve the flexibility of the economy to adjust to rapid changes in our resources and technology.

This chapter deals with policies to:

— increase the flexibility of our labor force and our labor markets;
— strengthen competition and improve our methods of regulation;
— enlarge consumer information;
— encourage the spread of civilian technology;
— spur regional recovery and industrial adjustment; and
— promote efficiency in Government.

Policies to foster a more flexible economy serve broad economic and social objectives. Full employment is promoted by fitting workers for available jobs. Price stability is served by increasing competition in industry. Simultaneous achievement of full employment and price stability are enhanced by encouraging the movement of labor and capital in response to changes in demand for final products. By equipping workers, firms, and regions to contribute more effectively to our general prosperity, these policies help to assure a wider and more equitable distribution of the benefits of prosperity.

A dynamic economy involves change, and change creates the need for adjustment. Old techniques of production give way to new, making workers' skills obsolete and destroying the value of old capital and materials. The composition and the character of products change, raising the prosperity of some industries but leaving others behind. And as our products and technology change and resources are exhausted, the pattern of industrial location alters, and whole areas may suffer high unemployment and economic decay.

If our economy is to maintain its capacity to grow, Government must ease the human adjustments to economic change and assure the redirection of people and capital to new purposes. Fortunately, improvements in the adjustment capability of the economy serve both purposes: the most effective way to reduce the human cost of adjustment is to restore the productivity of the affected people, industries, and areas, thereby enhancing growth.

## TOWARD A MORE PRODUCTIVE USE OF OUR LABOR FORCE

America's great productive capability is due to a highly productive labor force. It reflects the health, education, skill, mobility, and motivation of the people, as well as the Nation's capital stock and advanced state of technology. If the contribution of the labor force is to continue growing, our human resources must be further strengthened and the effectiveness of our labor markets must be improved. Only then will each worker find the employment in which his potential productivity is greatest.

A labor market that efficiently matches workers and job opportunities also serves other objectives of economic policy. It permits raising the sights of our employment targets without risking inflation, thereby helping to reconcile two vital policy objectives, full employment and price stability. It plays a key role in restoring to a productive life workers displaced by technological change and in guiding new workers into areas of expanding job opportunities.

The American economy has traditionally been characterized by an adaptable and highly mobile labor force. Members of this labor force—generally better educated and trained than those of any other country in the world—have filled the jobs created by advancing technology and have responded to shifting patterns of final demand.

The changes that have occurred have been enormous. Some have taken place so smoothly that we have barely been aware of them. This has been the case, particularly, when the total number of jobs was sufficient—when the market had enough jobs to allocate. Other adjustments have been more difficult, leaving in their wake high unemployment rates and poverty for some groups. Government must focus its effort on those changes which the market cannot carry through without personal hardship, even in a high-employment environment.

The task of economic analysis is to identify both those changes that the market cannot carry through effectively on its own and those that can and should be left to market forces.

## CHANGES IN THE COMPOSITION OF EMPLOYMENT OPPORTUNITIES AND OF THE LABOR FORCE

Changes in the over-all pattern of employment in this century have been substantial (Table 13). The amazing rise of productivity in agriculture and the slower growth of demand for its products reduced the percentage of the work force in farm occupations steadily and continuously, from almost 40 percent at the turn of the century to only 5 percent today. The revolution in management and marketing techniques and the growth of service industries and professions increased the share of white-collar employment from 18 percent to 44 percent during the same period. The share of employment accounted for by blue-collar occupations has been generally steady, but the amount of unskilled work has declined sharply as mechanical and electrical power have replaced human energy.

TABLE 13.—*Distribution of the economically active civilian population, by major occupation group, selected years, 1900–64*

[Percent]

| Major occupation group | 1900 | 1920 | 1940 | 1960 | 1964 [1] |
|---|---|---|---|---|---|
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100 |
| White-collar workers | 17.6 | 24.9 | 31.1 | 42.3 | 44 |
| Professional, technical, and kindred workers | 4.3 | 5.4 | 7.5 | 11.4 | 12 |
| Managers, officials, and proprietors except farm | 5.8 | 6.6 | 7.3 | 8.5 | 9 |
| Clerical and kindred workers | 3.0 | 8.0 | 9.6 | 14.9 | 16 |
| Salesworkers | 4.5 | 4.9 | 6.7 | 7.4 | 7 |
| Blue-collar workers | 35.8 | 40.2 | 39.8 | 39.6 | 39 |
| Skilled workers [2] | 10.5 | 13.0 | 12.0 | 14.3 | 14 |
| Semiskilled workers [3] | 12.8 | 15.6 | 18.4 | 19.9 | 20 |
| Unskilled laborers [4] | 12.5 | 11.6 | 9.4 | 5.5 | 5 |
| Service workers | 9.0 | 7.8 | 11.7 | 11.7 | 13 |
| Private household workers | 5.4 | 3.3 | 4.7 | 2.8 | 3 |
| Service workers, except private household | 3.6 | 4.5 | 7.1 | 8.9 | 10 |
| Farm workers [5] | 37.5 | 27.0 | 17.4 | 6.3 | 5 |

[1] Estimated from Monthly Labor Force Survey data, using 1960 Census data as benchmark.
[2] Craftsmen, foremen, and kindred workers.
[3] Operatives and kindred workers.
[4] Laborers, except farm and mine.
[5] Farmers, farm managers, farm foremen, and farm laborers.

NOTE.—Data relate to June 1900, January 1920, and April for the years 1940, 1960, and 1964. Detail will not necessarily add to totals because of rounding.

Source: Department of Commerce.

The employment changes have resulted from shifting patterns of demand for labor—as the techniques of production and the nature of the final products have changed—in combination with the rising educational attainment of the labor force. In 1900, 6 percent of the high school age population received secondary school diplomas; today this figure exceeds 70 percent. The percentage of the college age population enrolled in college increased from approximately 4 percent to 36 percent. As shown in Table 14, median years of schooling among the civilian labor force, aged 18 to 64, rose by one-third between April 1940 and March 1964—from 9.1 to 12.2 years.

TABLE 14.—*Distribution of civilian labor force 18 to 64 years of age, by educational attainment, 1940, 1952, and 1964*

| Years of school completed | April 1940 | October 1952 | March 1964 |
|---|---|---|---|
| | Percent | | |
| Total, 18 to 64 years of age | 100.0 | 100.0 | 100.0 |
| Less than 5 years | 9.2 | 6.8 | 3.4 |
| 5–8 years | 40.4 | 29.6 | 20.0 |
| 9–11 years | 18.4 | 19.1 | 19.4 |
| 12 years | 19.7 | 27.8 | 35.4 |
| 13–15 years | 6.5 | 8.5 | 10.7 |
| 16 years or more | 5.7 | 8.1 | 11.2 |
| Median school year completed | 9.1 | 11.1 | 12.2 |

NOTE.—Detail will not necessarily add to totals because of rounding.

Sources: Department of Commerce and Department of Labor.

The portion of the work force with eight years or less of education—that is, the group particularly ill suited to work under conditions of modern technology—declined in a generation, from 50 percent of the labor force to 23 percent. Today this group consists primarily of people beyond the age of 45, and its number is shrinking rapidly.

## LABOR MARKET ADJUSTMENT

The effectiveness of labor markets in adjusting to change will receive one of its severest tests in the next few years. The composition of demand for labor will continue its gradual shift toward higher skill levels. But the more dramatic changes will come on the supply side of the market as the size of the labor force expands rapidly and its composition is substantially altered.

The degree of flexibility in the network of labor markets is not the same for different groups or different types of adjustment. This is illustrated below in two ways. First, some major long-run trends in the supply and demand for labor are presented to illustrate how the economy has been adjusting to change. Employment and unemployment among female, Negro, teenage, and part-time workers show a variety of responses to the changes in labor market conditions. Second, the adequacy of the balance of skills demanded and supplied is examined: years of education, occupational skills, and industrial attachment play an important part in this balance.

*Women resuming job careers*

The response of the labor force to rapidly increasing job opportunities is most clearly demonstrated by the growth of the female labor force. Both the number of women seeking work and the number of jobs open to them rose sharply in the postwar period. Women constituted only a quarter of the labor force in 1947, but between 1947 and 1964 they provided 58 percent of the growth in the labor force and 64 percent of the increase in employment.

Of the total of 9.5 million additional women in the labor force, half was due to the growth of the female population and half was due to the rising percentage of women looking for jobs. Women between 45 and 64 particularly became more active job-seekers. In 1947, 29 percent chose to be in the labor force; by 1964 the figure had risen to 47 percent. Most of these women moved into the rapidly growing employment opportunities in trade and service sectors of the economy. The flexibility of the labor market is shown by the fact that the unemployment rate for older women has fallen relative to the total female unemployment rate despite the much more rapid growth of the numbers of older women seeking work. These women still constitute a sizable reservoir of talent—some highly trained—available to respond to further expansion of demand for their services.

*Negroes seeking employment opportunities*

The adjustment powers of the labor market have been least adequate for Negroes. During the postwar recessions, a disproportionately large number of Negroes lost their jobs; when recovery came, many of them were not reemployed. Part of this was due to inadequate training, part to job discrimination. In addition, the Negro labor force grew somewhat faster than the white, particularly in urban areas where migration from farm to city was a major element. In both 1950 and 1964, the unemployment rate for whites was 4.6 percent, but the rate for Negroes rose from 8.5 percent in 1950 to 9.8 percent in 1964. Despite a reduction during the past year, Negro unemployment is more than twice that for whites. The ultimate elimination of this difference must be a key goal of our manpower policies.

*Teenagers entering the labor force*

The great increase in the number of young, inexperienced workers constitutes the most important change in the labor force during this decade. Recent increases in teenage employment, cited in Chapter 1, are an encouraging sign of the labor market's ability to absorb inexperienced workers when total employment rises rapidly. Yet relatively high teenage unemployment rates, 15 percent in 1964, make it clear that an insufficient number of jobs is channeled to this group.

Future increases in the number of teenagers will provide an even more severe test of the adaptability of the labor market. Because of the low birthrates during the Great Depression and World War II, the number of teenagers in the labor force actually declined through the mid-1950's. It then began to rise and by 1960, there were 5.8 million persons aged 14–19 in the labor force; by 1964, the number had increased to 6.5 million; and by 1966 it is expected to be 7.5 million. Thereafter the rate of increase will slow appreciably. Without specific policy measures aimed to improve the access of teenagers to job opportunities, their unemployment rates will continue to be high under any except labor shortage conditions. The successful absorption of these new workers into high-productivity jobs is the greatest test now confronting our labor market and our general economic and manpower policies.

*Teenagers and women seeking part-time employment*

Increases in part-time employment are closely related to the larger number of females and teenagers in the labor force. Many women and teenagers seek part-time jobs that will permit them to keep house or go to school but still provide opportunities to supplement family income. Between May 1957 and May 1964, the part-time labor force increased by 3 million, to a total of 8.8 million. Adult women (20 years of age and above) and teenagers of both sexes accounted for most of the increase.

During this period, part-time employment rose by 2.7 million, resulting in an increase in the rate of part-time unemployment paralleling the rise in the full-time rate. The continuous expansion of the female and teenage population groups will cause the part-time labor force to increase further.

Every major industry increased its proportion of part-time workers, with the most significant increases occurring in wholesale and retail trade and in services and finance. These two industries not only provided the bulk of the private economy's employment gains, they also provided most of the increase in part-time employment. Manufacturing industries offered relatively less part-time work because of the difficulty of adjusting production schedules.

*Balance of labor skills and requirements*

Unemployment rates for skilled occupations are well below average rates, but show two rather different trends. The rates for craftsmen and foremen have fallen recently relative to the total rate, while those for professional and technical workers have risen. In 1964, the unemployment rate for craftsmen and foremen was 4.2 percent, the lowest since 1956. The rate for professional and technical workers was 1.7 percent in 1964, substantially above levels in the mid-1950's (Table 15).

The relative decline of unemployment for craftsmen and foremen may be due to an increase in the relative demand for skilled workers or to the effect of an extended period of high unemployment on the supply of this type of labor. Since much of the training for skilled workers is acquired in apprenticeship and other on-the-job training programs, this particular labor force grows very slowly during a period of high unemployment. Few new workers are hired, workers laid off may go to other industries, older workers retire, and the number of people admitted to apprenticeship programs falls. When job expansion resumes, the labor force is smaller, and the unemployment rate drops quickly.

TABLE 15.—*Unemployment rates by major occupation group, 1957–64*

[Percent [1]]

| Major occupation group | 1957 | 1959 | 1962 | 1946 |
|---|---|---|---|---|
| Total | 4.3 | 5.5 | 5.6 | 5.2 |
| White-collar workers: | | | | |
| Professional, technical, and kindred workers | 1.2 | 1.7 | 1.7 | 1.7 |
| Managers, officials, and proprietors, except farm | 1.0 | 1.3 | 1.5 | 1.4 |
| Clerical and kindred workers | 2.8 | 3.7 | 3.9 | 3.7 |
| Sales workers | 2.6 | 3.7 | 4.1 | 3.4 |
| Blue-collar workers: | | | | |
| Craftsmen, foremen, and kindred workers | 3.8 | 5.3 | 5.1 | 4.2 |
| Operatives and kindred workers | 6.3 | 7.6 | 7.5 | 6.5 |
| Laborers, except farm and mine | 9.4 | 12.4 | 12.4 | 10.6 |
| Service workers: | | | | |
| Private household workers | 3.7 | 4.8 | 4.9 | 4.9 |
| Service workers except private household | 5.1 | 6.4 | 6.4 | 6.1 |
| Farm workers: | | | | |
| Farmers and farm managers | .3 | .3 | .3 | .5 |
| Farm laborers and foremen | 3.7 | 5.1 | 4.3 | 5.8 |

[1] Unemployment as percent of civilian labor force in group.

Source: Department of Labor.

Increases in the unemployment rate for professional and technical workers since 1959 are partly linked to unemployment among those individuals who have college training (Table 16). Increased flows of young college graduates into the labor force in the past several years have eased shortages that may have been felt earlier in this particular segment of the labor market. Shifts in defense production have also reduced the demand for these classes of workers.

Employment trends for less skilled labor, persisting since the Korean war, have recently been reversed. During the period in which the gap between actual and potential output developed, employment of semiskilled factory operatives, for example, expanded at a much slower rate than total employment. As a result their unemployment rate rose. But the acceleration of economic expansion in 1964 was felt particularly in the Nation's factories, creating many employment opportunities for operatives. Between 1962 and 1964, when total employment increased by 4 percent, employment of operatives rose by more than 7 percent. This has reduced their unemployment rate from 7.5 to 6.5 percent (Table 15).

TABLE 16.—*Unemployment rates of males 18 years of age and over, by educational attainment, selected dates, 1952–64*

[Percent [1]]

| Years of school completed | 1952 | 1957 | 1959 | 1962 | 1964 |
|---|---|---|---|---|---|
| Total | 1.5 | 4.1 | 6.3 | 6.0 | 5.2 |
| Less than 8 years | 2.3 | 6.9 | 9.8 | 9.2 | 8.4 |
| 8 years | 1.4 | 4.4 | 7.3 | 7.5 | 6.9 |
| 9–11 years | 1.6 | 4.7 | 8.1 | 7.8 | 6.6 |
| 12 years | 1.1 | 3.0 | 4.9 | 4.8 | 4.1 |
| 13–15 years | 1.1 | 2.7 | 3.3 | 4.0 | 3.8 |
| 16 years or more | .4 | .6 | 1.4 | 1.4 | 1.5 |

[1] Unemployment as percent of civilian labor force in group.

NOTE.—Data relate to March of all years except 1952. Data for 1952 relate to October.

Source: Department of Labor.

With an expanding economy, the employment situation for those with less education has improved. As shown in recent years, an adequate rate of growth expands employment opportunities in industries and occupations where semiskilled and unskilled workers can find jobs. If growth is not adequate, the unskilled and semiskilled are the ones who find jobs most difficult to locate. Furthermore, rapid and sustained expansion facilitates the adjustment to changing skill requirements by providing continuing opportunities for acquisition of new skills on the job.

### *Unemployment in durable goods industries*

Looking at the balance of skills and workers by industry rather than by occupation reveals that the employment opportunities in durable goods manufacturing have risen particularly sharply with the accelerated rate of growth of the past few years. With an unemployment rate of 4 percent by the end of 1964, the pool of unemployed workers in durable goods manufacturing was smaller than in any year since the Korean war. During the years of high unemployment, the labor force of this industry group shrank, as some workers switched to other industries and those who retired or died were not replaced. The continuing growth of durable goods production will test the ease with which the durable goods labor force can be expanded once again. A combination of job opportunities and high wages will attract labor to these industries, but firms will have to train these workers instead of relying on the recall of unemployed skilled workers. This would be a return to the historic role of these industries of drawing in the unskilled young workers and workers from rural areas and training them on the job. To channel some of the greatly increasing number of new workers into the durable goods industries will be one of the great challenges to private and public manpower policies. Today, teenagers account for 9 percent of the labor force, but only 3 percent of workers in durable good industries.

## MANPOWER POLICY

An active manpower policy—sensitive both to the strengths and the limitations of the labor market—must develop our manpower resources to give everyone the opportunity to make the best use of his abilities, and must improve the organization of the labor market to provide the best possible matching of people and jobs, without regard to race, creed, sex, or age.

### *Creating jobs*

Between now and 1970, about 1.5 million new jobs a year will be needed to absorb the growing labor force and to reduce unemployment to a 4 percent level. Furthermore, output, income, and jobs will have to expand to offset normal increases in output per man-hour. Even more jobs and lower unemployment can be achieved through effective policies.

Major responsibility for achieving our employment objectives must rest with fiscal and monetary policies. In addition, we shall need policies aimed at developing our manpower resources, increasing the efficiency with which labor markets adjust to changes in the demand for and supply of labor, and revitalizing depressed areas. This combination of policies will reduce the likelihood that inflation will impede the pursuit of full employment and will ameliorate the human costs incident to a changing job market.

*Developing manpower resources*

Our system of general education is the foundation upon which specific occupational and professional skills are built. It provides an adaptability to change that pays dividends throughout an individual's work life. The problems of providing universally accessible educational opportunities of high quality are considered in Chapter 4.

Occupational competence is obtained in many ways, including on-the-job training organized by employers; apprenticeship and union-sponsored training programs; private technical institutes; trade and business schools; the Armed Services training programs; and Federal, State, and local government programs.

The Department of Labor has studied the ways in which labor force participants with less than three years of college education acquired their occupational and professional training. As shown in Table 17, about one-third of those interviewed had formal training (in schools, apprenticeship programs, or the armed forces) to prepare them for their vocation; only 7 percent of laborers, but 65 percent of professional and technical workers, had this kind of preparation. Among skilled workers and foremen, 41 percent had formal training. All but a few of the least-skilled categories contained high percentages with on-the-job training. Casual methods were important for all categories.

Public policy is increasingly focused on the needs of the young and the disadvantaged. Our rapidly growing teenage labor force must be enabled to acquire the skills required in today's world. Negroes must be prepared for the skilled jobs that will become increasingly available to them as discriminatory barriers are removed. And older workers displaced by technological change must be reequipped for new jobs.

Vocational education is an important type of formal training to prepare youth for skilled jobs. Yet experience with training programs in recent years has revealed the limited scope and obsolescence of some of our public vocational education. High school programs that include generous amounts of general education and concentrate on skills relevant to clusters of occupations are most likely to provide students with the flexibility to adapt to future occupational changes. The Vocational Education Act of 1963 was designed to meet that objective. In cooperation with State and local educational systems, the Act provides programs for all age groups, from high school students and dropouts to adults who can profit from training or upgrading or who need specialized training to become reemployed. It also calls for systematic review of the curriculum of the programs.

TABLE 17.—*Training taken by persons in civilian labor force*[1]

| Current occupational group | Percent reporting job learned by— | | | Percent reporting no training needed |
|---|---|---|---|---|
| | Formal training[2] | On-the-job training[3] | Casual methods[4] | |
| Total | 30.2 | 56.2 | 45.4 | 7.5 |
| White-collar workers: | | | | |
| Professional, technical, and kindred workers | 64.6 | 66.7 | 33.2 | 2.1 |
| Managers, officials, and proprietors, except farm | 36.2 | 57.1 | 55.7 | 4.0 |
| Clerical and kindred workers | 53.6 | 71.4 | 29.5 | 2.0 |
| Sales workers | 23.4 | 60.2 | 47.4 | 7.5 |
| Blue-collar workers: | | | | |
| Craftsmen, foremen, and kindred workers | 40.6 | 64.8 | 47.5 | 1.8 |
| Operatives and kindred workers | 12.9 | 61.8 | 42.6 | 8.6 |
| Laborers, except farm and mine | 6.9 | 40.0 | 50.5 | 18.1 |
| Service workers: | | | | |
| Private household workers | 10.3 | 9.3 | 56.4 | 27.9 |
| Service workers, except private household | 24.6 | 45.5 | 42.7 | 13.5 |
| Farm workers: | | | | |
| Farmers and farm managers | 20.6 | 17.6 | 79.7 | 8.4 |
| Farm laborers and foremen | 11.1 | 19.2 | 64.8 | 17.7 |

[1] Data relate to survey taken in April 1963.
[2] Includes training obtained in schools of all kinds (company training schools as well, where training was full-time and lasted at least 6 weeks), apprenticeship, and armed forces.
[3] Includes on-the-job training by supervisors, company training courses (part-time, or full-time for less than 6 weeks), and "worked way up by promotion."
[4] Includes learning from a relative or friend, "just picked it up," and other such methods.

NOTE.—Since about one-third of the respondents indicated more than one way, the sums of the percentages exceed 100. These figures include all civilian labor force participants aged 22 to 64 with less than 3 years of college. For the unemployed, data relate to the last job held.

Source: Department of Labor.

Apprenticeship is another important system for training youth to be skilled workers. About two-thirds of apprentices are in programs registered under the Department of Labor. The remaining one-third are mainly in unregistered courses run by large employers. Small firms have been generally inhibited by the cost of training and by their inability to insure that trained workers would remain with the firm. Recently, these costs have been lessened by funds made available under the Manpower Development and Training Act (MDTA) for pre-apprenticeship and on-the-job training programs. The extent of the apprenticeship training programs depends on the current and anticipated need for trained labor. Therefore, prosperity encourages on-the-job training. However, employers cannot recover the full benefits of such programs, since workers trained at their expense may move to other employers. Thus, cooperative programs by groups of employers should be encouraged.

Three Government programs started in recent years have been directed at helping those in especially unfavorable circumstances to acquire the attitudes and skills that will enable them to attain, or regain, employment.

The Area Redevelopment Administration (ARA), established in 1961, has provided training and training allowances for unemployed and underemployed persons in depressed areas. Training has been provided for more than 40,000 workers, about 70 percent of whom have found jobs.

MDTA programs were established in 1962 to offer training for unemployed and underemployed workers with previous work experience. Training allowances were provided for a period of up to 52 weeks. Training, mostly in institutional programs, has been authorized for more than 350,000 persons. Machine operation and auto repair work have been the most common courses for men, and clerical and nursing courses for women.

The Economic Opportunity (Anti-Poverty) Act will emphasize work and training for youth through such programs as the Neighborhood Youth Corps, the Job Corps, and the Work-Study Program. These are discussed in greater detail in Chapter 4.

*Improving the functioning of the labor market*

For the labor market to operate efficiently, job opportunities must be open to all qualified individuals; workers must have knowledge of alternative employment opportunities; and employers must have a means of making their manpower needs known. It is therefore important that unions and professional and business organizations avoid restrictions on entry and hiring designed to enhance the incomes and employment opportunities of the restricted group. Such restrictions can be as injurious as monopoly in the sale of goods.

About three-quarters of all jobs are now filled without the use of any placement agency, public or private. But the way in which the remaining jobs and workers are matched may spell the difference between an efficient and an inefficient labor market. The 1,900 State employment service offices affiliated with the U.S. Employment Service are designed to fulfill this task.

Many of the young teenage labor force entrants need testing and counseling if they are to make wise vocational choices. The State employment services, in cooperation with the schools, now provide testing services to approximately one-half of the Nation's high schools. Counseling and testing are provided for about one-fifth of the new applicants at employment service offices.

The employment service should be available to all workers, regardless of occupation or current employment status. Greater separation of unemployment insurance activities from other employment service functions is desirable to strengthen counseling, training, referral, and placement activities. In large metropolitan areas, employment service offices that specialize by industry can provide better services to both employers and workers in those industries than can be supplied by offices that try to cover the whole range of industries. Specialized offices are now in operation in 41 of the 56 largest metropolitan areas.

In addition, special services are required for those who are at a competitive disadvantage in the labor market—the inexperienced, the undereducated, the unskilled, older workers, the handicapped, and minority groups. Some special services for these groups are now being provided—including those related to ARA, MDTA, and anti-poverty programs. During the coming year, emphasis will be placed on employment services for younger persons. The services will include exploratory interviews, counseling, and testing; referral to community agencies for diagnostic and remedial assistance; and strengthening of placement efforts, including those directed at rapidly expanding part-time employment opportunities.

An effective manpower policy also will require better information on the current and future structure of supply and demand in local labor markets. Experimental surveys of job vacancies during the coming year will help to fill an important gap in manpower statistics.

The employment service can become an important aid to geographic mobility in our dynamic economy. An increase in interarea exchange of job information can contribute to this goal. The current experimental program in the use of relocation allowances, revised and expanded as necessary, can help to translate this interarea information into effective placements.

The Nation's flexible labor markets have enabled us to adapt to dramatic changes in labor supply and demand. They provide a solid foundation upon which to build an effective manpower policy that can both increase the efficiency of the labor market and open up new opportunities for those burdened by past disadvantages or faced with exceptionally difficult shifts in market supply or demand.

A manpower policy that is geared to steady employment for all who seek work, that deals responsively with the income, training, and placement needs of the unemployed, and that meets the special problems of distressed areas and groups will reinforce the ability of our economy to grow and will facilitate adjustment to change.

## COMPETITION AND REGULATION FOR A FLEXIBLE MARKET ECONOMY

Decentralization of economic power has long been considered desirable for social and political reasons, as well as for its contribution to an efficient economy. Absence of active competition tends to result in higher prices and lower output, and thus in a less efficient allocation of resources. Noncompetitive industries may also lack the spur to innovation and change, as sellers find it easier as well as more profitable to use obsolete facilities or produce familiar products. They may be less concerned with keeping their costs under control if they have no difficulty in passing higher costs along to their customers.

Yet modern technology requires large-scale operation in many industries, and, for the most part, our society reaps the benefits in the form of lower costs, better quality, and continuing research and innovation. In many industries, a high concentration of output among a small number of firms is not inconsistent with highly active competition, especially where there is also a fringe of small firms, where entry of new firms is easy, or where there exists active competition from substitute products. Yet it is also true that it is often easy for firms to avoid competition when an industry is dominated by a small number of very large firms. It is the difficult task of public policy to preserve the benefits of competition while retaining the advantages of our complex and highly productive industrial system. And even where competition is imperfectly effective, it may sometimes be preferable to tolerate the imperfection if the only alternative is complicated Government regulation—which, unless carefully and regularly reviewed, may become bureaucratized, rigid, and possibly dominated by the interests of those regulated.

### TRENDS IN INDUSTRIAL STRUCTURE

The U.S. economy is large, complex, and fluid. It contains about 5 million businesses and 2 million commercial farms. Within the manufacturing sector alone, there are more than 300,000 firms, of which 175,000 are corporations. During 1964 nearly 500,000 new businesses were started. Thousands more were discontinued or merged, or transferred their operations from one industry or locality to another.

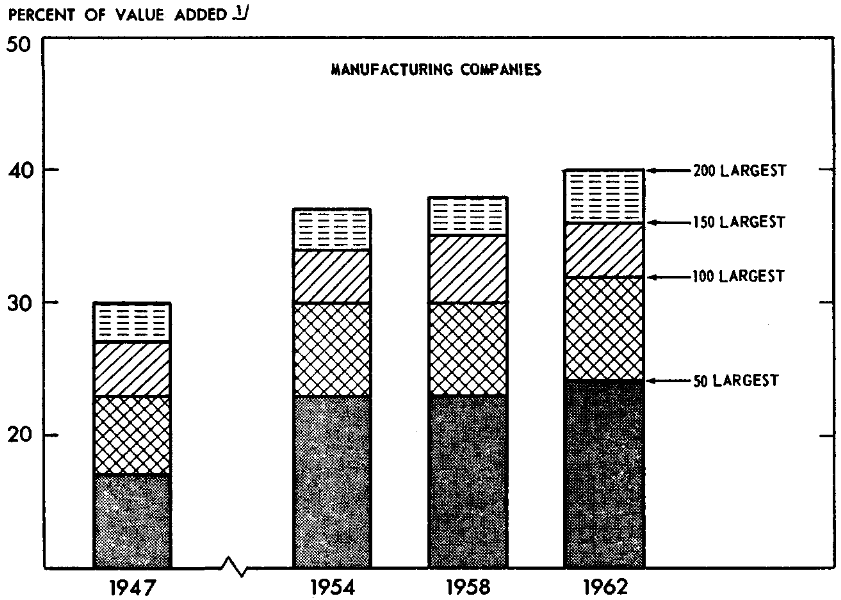
Within the important manufacturing sector, certain structural trends have emerged in the period since the end of World War II: (1) Through internal expansion and merger, large firms have grown more rapidly than the manufacturing sector as a whole. As a result, their share of the *total* market for all manufactured goods has risen. (2) Within some individual industries, the concentration of production in the hands of the 4 firms with the largest shares of the market has increased; in others it has decreased. Over-all, concentration within specific industries has shown no significant trend.

The market share of the 100 largest U.S. manufacturing firms has grown rapidly since World War II. Chart 14 shows that, between 1947 and 1962, their share of value-added in manufacturing grew from 23 percent to 32 percent. And their share of all manufacturing assets increased from 39 to 45 percent between 1950 and 1962. Partly this has resulted from expanding markets in a growing economy and from able and efficient management. It has resulted also from the postwar merger movement which will be discussed below.

Chart 14

## Shares of Largest Companies in Manufacturing

AS MEASURED BY VALUE ADDED




1/ VALUE ADDED IN MANUFACTURING.
SOURCE: DEPARTMENT OF COMMERCE.

Concentration within specific industries is frequently measured by the share of an industry's shipments attributable to the 4 firms with largest shipments. Table 18 shows that this measure of concentration has risen in some major manufacturing industries but fallen in others. In 1947, 24 percent of manufacturing shipments were in industries in which the 4 firms with largest shares of the market accounted for at least half the shipments. In 1958, the figure was 23 percent, indicating little, if any, trend during the period.

An important part of the explanation of these opposing movements—the increasing influence of large firms in total manufacturing activity while concentration in specific industries shows no significant trend—can be found in the size and character of the postwar merger movement. The Federal Trade Commission has recorded more than 11,000 mergers since 1948. Since 1950, the 200 largest industrial corporations have acquired more than 2,000 other concerns, and 257 of the 1,000 largest manufacturing corporations have disappeared through merger. Mergers of large firms grew rapidly in number and importance from the end of World War II until 1955, fell off briefly, and then continued to grow again after 1959.

TABLE 18.—*Concentration in selected industries, 1947 and 1958*

| Industry | Value of shipments 1958 (millions of dollars) | Percent of value of shipments accounted for by 4 largest firms | |
|---|---|---|---|
| | | 1947 | 1958 |
| Primary aluminum | 802 | 100 | (1) |
| Locomotives and parts | 387 | 91 | 95 |
| Tin cans and other tinware | 1,804 | 78 | 80 |
| Cigarettes | 2,159 | 90 | 79 |
| Computers | 1,076 | 69 | 77 |
| Motor vehicles and parts [2] | 6,419 | 56 | 75 |
| Tires and inner tubes | 2,272 | 77 | 74 |
| Aircraft engines | 3,359 | 72 | 56 |
| Steel works and rolling mills [2] | 5,980 | 50 | 53 |
| Electric appliances | 755 | 36 | 43 |
| Meat packing plants [2] | 1,677 | 41 | 34 |
| Cement, hydraulic | 1,069 | 30 | 32 |
| Petroleum refining | 14,106 | 37 | 32 |
| Machine tools | 685 | 20 | 21 |

[1] Not available.
[2] Data are for value added rather than value of shipments.

Source: Department of Commerce.

Earlier merger movements were characterized largely by "vertical" acquisitions among firms that were in a buyer-seller relationship and by "horizontal" acquisitions among competing firms. Anticompetitive mergers of both kinds are now effectively prohibited by our antitrust laws. Many of the more recent mergers, however, have been "conglomerate"—that is, the acquisition by one firm of another in an unrelated product line, normally to achieve economies of management or sales or diversification of risks. These, too, are subject to the antitrust laws, but their effects on competition are more complex and more difficult to establish. On the one hand, it can be noted that an already large firm in another industry which finds it easy to enter new product lines is often the most effective source of active or potential competition in a product market that has become imperfectly competitive. On the other hand, a large conglomerate firm may be able to reduce competition in an industry previously characterized by small firms.

Expansion into new and unrelated product lines, whether by conglomerate merger or by the creation of new capacity, has permitted an increase in the share of the total manufacturing market supplied by large firms, without increasing (and perhaps with decreasing) concentration within individual industries. In 1958, one or more of the 100 largest manufacturing concerns were among the 4 firms with the largest shipments in 550 of the 1,014 product classes identified by the Census of Manufactures. And 95 of the 100 largest companies were among the 4 leading producers in 2 or more product classes.

## POLICIES TO MAINTAIN COMPETITIVE MARKETS

Our antitrust laws have helped to achieve the delicate balance between the economic benefits which flow from the research, innovation, and advanced technology of large scale business organizations, and the adverse effects of unnecessary or artificial obstacles to competition. In the 75 years since the passage of the Sherman Act, the Congress and the courts have attempted to adapt our antitrust laws both to our changing economic system and to our growing understanding of how that system operates.

Legislative, judicial, and enforcement activities have all contributed to the strengthening and clarification of our antitrust policies in the postwar period. Enforcement activity has been vigorous during each of the postwar Administrations, attesting to the bipartisan nature of the Nation's belief in maintaining maximum competition consistent with a productive and efficient economy.

A series of judicial interpretations since 1945 has helped to clarify the meaning of the laws. More precise criteria have been developed with regard both to the structure of industry—the degree of concentration that generates excessive market power—and to the performance of industry—the abuse of market power.

Concern over the growing postwar merger movement led to a strengthening of the Clayton Act in 1950. Subsequent judicial decisions have confirmed that horizontal or vertical mergers through the purchase of stock or assets are illegal, whether consummated in the past or proposed for the future, if they may have the effect of substantially reducing competition. The law with regard to conglomerate merger is not yet clear. Further cases would define the law more precisely. The uncertainty which surrounds existing law, while in part unavoidable, imposes many costs and limitations on business, some of which could probably be eliminated without significant loss to enforcement of antitrust policy.

Effective antitrust policy involves a close partnership between economics and the law. Sound economic analysis needs to be used to define the relevant market, to assess the extent of concentration and barriers to entry of new firms, and to evaluate business policies. Equally important is the development of sound economic criteria for the selection and preparation of antitrust cases, since the desirability of many business actions depends on their economic setting and significance.

## FEDERAL REGULATION OF ECONOMIC ACTIVITY

In the vast majority of industries, competition is the most effective means of regulation. But in a few industries, technological and economic factors preclude the presence of more than one or a few firms in each market. When these industries provide an important service to the public, direct control is substituted for competition. The independent Federal regulatory commissions were established in the transportation, power, and communication industries because competition could not be expected to protect the public interest. In other areas, regulation is aimed at providing the public with reasonably full knowledge of the market. In particular, securities and certain commodity markets have become so complex and technical that regulation is necessary to insure that buyers and sellers have access to accurate and reasonably comprehensive information.

It is important that regulatory policies be adapted to changing needs and conditions. Economic and technological progress may lead to changes in the desirable scope and method of regulation. In some important cases, competition has become substantially more effective since regulation was first established. In cases where competition is not possible, there may be alternatives more effective than regulation. The establishment of Comsat, a joint public-private venture in the area of space communications, is an example of a new institution designed to take advantage of a new technological opportunity.

The fields of transportation and electric power offer illustrations of the changing circumstances of regulated industries.

*Transportation*

Technological and economic changes have revolutionized the transportation industry since the establishment in 1887 of the Interstate Commerce Commission, our first independent regulatory commission. Technological progress has led to the introduction and development of highway, air, and pipeline transportation, which now supplement and compete with rail and water transportation. The latter could, in turn, compete more effectively with the newer forms—and to their own and the public's benefit—if they were not restrained by certain aspects of regulation.

The transportation revolution has created a variety of alternative means for the movement of people and goods. Few communities or industries are dependent now upon a single means of transportation for access to the outside world, as was normally the case in the 19th century. Given these new alternatives, there are some respects in which it would be desirable to increase the role of competition and the scope for initiative among transportation companies. Appropriate reduction of the scope of Government supervision over rates (particularly minimum rates) and, in some cases, over the choice of operating routes would strengthen competition among various modes of transportation, increase efficiency in the utilization of transportation resources, and encourage more rapid technological progress. At the same time, there is an increasing need for improved planning and coordination of intercity as well as urban mass transit systems.

*Electric power*

Technological progress in the generation and transmission of electricity has resulted in a need for coordination and integration of the Nation's power systems. Large generating plants can yield substantial economies, whether they use atomic or conventional fuels. The development of extra high voltage transmission lines permits electricity to be sent economically over long distances. The Federal Power Commission, in its National Power Survey, has recently documented the great economies available from an intensified program of interconnection and coordination among the 3,600 separate power systems in this country.

In some cases, economies in generation can be realized by substituting one large plant for several individual plants, each serving a single small community. Interties between systems permit economies from the coordinated operation of several systems: power can be shared between systems with noncoincident peakloads; reserve generating capacity for breakdowns, maintenance, and unexpected demands can be shared; the building of new capacity can be staggered between neighboring systems to meet growing demands without the waste of idle capacity; better use can be made of scarce hydro and steam plant sites; and greater flexibility in plant location can reduce urban air pollution problems.

Our national power supply system consists of a variety of public, private, and cooperative institutions. Exploitation of modern technology requires increased emphasis on the planning, coordination, and operation of large systems. This will require cooperation among all types of power suppliers and experimentation with new forms of public and private planning. Such experimentation has begun with the Pacific Northwest to Southwest intertie. The National Power Survey points to the many opportunities that lie ahead.

## CONSUMER INFORMATION

The end use of nearly two-thirds of production is current consumption. Even the most efficient productive system will not create a high level of economic welfare unless consumers can make free and informed choices.

With a rising GNP, the spectrum of goods and services available to consumers has widened, and our distribution system has become increasingly complex. Many new products have appeared, in part reflecting accelerated research and development expenditures of recent years, and in part reflecting the adaptability of American manufacturers and distributors in catering to new wants and desires of consumers.

All too often, however, consumers are not completely informed about products available, and sometimes products are misrepresented, whether by accident or intent. Most of the responsibility for providing consumer information rests with private producers and retailers. But where the consumer is not able to obtain honest information, the Government has a role to fulfill.

Consumers today are particularly subject to lack of information on the terms and costs of credit. Too often they are unaware of the full cost of a credit transaction, and are unable to compare financing costs because of nonstandard ways of reporting interest charges. The consumer credit system has helped the American economy to grow and prosper, but the cost of such credit must be made as clear and unambiguous as possible. The truth-in-lending bill, requiring the total dollar amount of the finance charges and the annual rate upon unpaid balances to be clearly stated to borrowers, would eliminate many of the abuses in the credit area.

Abuses have also become acute in the packaging of products sold in retail establishments. In today's marketing system, the package has become the silent salesman. The package, therefore, should present in a clear and comprehensive manner enough information to allow the consumer to make informed choices. The truth-in-packaging bill would assure consumers of simple, direct, visible, and accurate information as to the nature of the product and the quantity in the package.

## ASSISTING CIVILIAN TECHNOLOGY

The Council's last Annual Report contained a detailed analysis of the role of technological change in promoting economic growth and discussed major Government programs that help to advance civilian technology. Public interest in these matters is warranted since many markets tend to provide firms with insufficient incentives to allocate resources to research and development (R & D). Benefits of research tend to be widely diffused among many firms and even industries, making it difficult if not impossible for firms to reap the full benefits created by their research. Also, the uncertainty and high cost of many research projects may make the risks prohibitive for small and medium sized firms. These factors become more important, the more basic the research, since the results of such research are both more uncertain and more widely diffused. They explain why much basic research is and should be supported by Government and by educational and other nonprofit research organizations.

Advancing technology is an important element in strengthening our long-term international trade position. Last year, a large proportion of our exports of manufactures were from high technology industries, such as aircraft, data processing equipment, power generating equipment, and instruments. The high productivity of the workers employed in these industries, and the superior performance of the products, more than offset the lower wage costs in Europe and Japan.

Research and development manpower talent has always been a scarce and valuable resource. The supply can be expanded only slowly and at the cost of forgoing the services of technical personnel in managerial, administrative, teaching, and other positions. If the present tendency toward a leveling off in defense and space research and development expenditures continues, the resources of scientific and technical manpower available to the civilian economy will increase more rapidly than in the past. With an increase in the number of scientific and technical personnel available for civilian activities, business firms will be able to engage in civilian research and development projects which they could not previously undertake. They will be assisted by the 1964 and 1965 tax cuts which increase the aftertax return on R & D undertakings, as well as on capital investment.

Similarly, the Government can increase its own civilian research efforts. This is already being done in such areas as water desalting, supersonic air transportation, and urban mass transportation. The Northeast Corridor Project, to develop highspeed intercity passenger transportation over such routes as Boston to Washington, is a recent and important example.

The Department of Commerce has proposed a State Technical Services program to speed the spread of new technology. Under this program, designated universities would offer technical services designed to meet the needs of local industry. The services would include the analysis of local problems to determine needs that might be met by new technology, reference services, technical information centers, workshops, seminars, and training programs. The program would be financed by local resources and Federal matching funds.

Increased public and private support for higher education will strengthen the efforts of colleges and universities to undertake more nondefense research and to provide the humanistic and scientific education and technical training for our rapidly expanding student population. Greater support for university research will strengthen the base of pure science on which applied research and development depend.

## REGIONAL RECOVERY AND INDUSTRIAL ADJUSTMENT

The changes that accompany growth do not proceed evenly and continuously. Communities and even entire geographic regions whose fortunes are tied to a particular natural resource, pattern of transportation, or industry may decline as resources are depleted, technical changes destroy earlier locational advantages, or shifts in taste lead to decline of the base industry. Communities dependent upon a single firm for the bulk of their employment are especially vulnerable to shifts in demand or plant location, whether caused by market forces and private decisions or by changes in Government programs.

Other communities are simply bypassed by economic growth. They are the victims of a poor resource base, have never attracted adequate investment to develop their limited economic potential, and generally have suffered from many decades of underinvestment in education, health, and community facilities.

Once a community is in prolonged distress, its difficulties feed on themselves. Its capacity for maintaining social investments in education, health, and community services erodes. Young workers leave and there may be a loss of talent to more prosperous places. Eventually, loss of population can reduce the tax base below the critical level at which the existing scale of community institutions can be sustained, and the community is caught in an area-wide, self-perpetuating circle of poverty.

## AREA REDEVELOPMENT ACT

In 1961, the Congress passed the Area Redevelopment Act (ARA), providing distressed areas with grants and loans for public facilities, loans for commercial and industrial enterprises, technical assistance, and training programs for the unemployed. Areas were designated to be eligible for assistance on the basis of persistent unemployment above the national average, persistent low incomes, and a variety of other criteria. About 1,100 areas were declared eligible.

Unemployment in the designated areas fell from 10.4 percent in 1961 to 8.7 percent in 1963, while some areas improved to the point of being removed from the designated group. In 1964, the improvement accelerated, leading to the removal of an increasing number of areas from the eligible list. These gains resulted from economic expansion of the last four years; out-migration as employment prospects developed elsewhere; retirements and other withdrawals from the labor force; and the salutary effects of the ARA program.

The ARA projects have helped communities to plan for progress. Commercial and industrial ventures in designated areas have received more than $170 million in low-interest loans and assistance in establishing training programs. The communities have also received nearly $90 million of loans and grants for public facilities, and $35 million for technical assistance and training.

This experiment in regional development policy has shown that redevelopment can be facilitated by public programs. Analysis of the experience also points the way for the next steps to improve the effectiveness of Federal efforts. The principles that emerge are these:

First, the scale of assistance must be sufficient to make a significant impact on the economic structure of an area. Designation of too many areas reduces the possibility of providing aid sufficient to break out of the circle of poverty. Aid must be concentrated where it is most needed and where it gives the greatest promise of producing self-sustaining recovery.

Second, the regions to be aided should be large enough to include a resource base for self-sustained growth and to support the full range of community services and public utilities. However, they should not be so large that a considerable share of the aid may fall outside the communities in distress. The areas under the present programs were defined on a county or a labor-market basis. In some cases these were appropriate units, corresponding to genuine economic areas; but in other cases they were too small.

Because of the decrease in population, some counties have reached a point of decline where it is difficult to achieve self-sustaining recovery through Federal efforts. In such instances, the people of the area are likely to be better served by the expansion of job opportunities in towns within commuting distance.

Clusters of industry and commerce attract other firms; public facilities adequate to attract industrial and commercial growth are often difficult to provide in very small communities; adequate communication, low-cost transportation, and other necessary community facilities are more likely to be viable where industry and commerce are concentrated. Thus, Federal aid can be more effective if smaller local areas are induced to combine into larger development regions containing towns with potential to form the basis for self-sustained growth. These towns could develop the capability to employ workers from nearby distressed areas.

Third, new programs must place major emphasis on investment in those community facilities that are commonly deficient in depressed areas. Little real growth is possible without adequate water and sewerage facilities and other community services that directly affect the ability of an area to attract industry and commerce. Yet a long history of poverty and a weak tax base are likely to leave a community with inadequate funds—or borrowing power—to meet these preconditions. Federal grants to aid construction of some of these facilities are one of the key means for breaking a community's circle of poverty. In addition, they release local funds for further development efforts.

Fourth, if there is to be assurance that Federal aid to a region is to lead to recovery, the region must develop a plan for its progress. The communities of the region must work together, sharing the aided community facilities, planning land use for new industry, arranging for training and retraining of workers in new skills, and developing a program for attracting industry. The development of a meaningful plan should mobilize private and public local leadership of the region.

The President will propose renewal and revision of the ARA program shortly.

## APPALACHIA

Of the distressed areas of the country, Appalachia, with 355 counties in 11 States, is the largest and presents uniquely difficult problems. Always a poor rural region, its main source of prosperity, coal mining, has undergone a very sharp decline. For this reason, its redevelopment requires public measures not necessary in smaller areas. The Administration has established a special Appalachian Regional Commission; under the guidance of the Commission and the local development districts, a series of proposed programs were designed to develop human and material resources.

The resulting Administration proposals include new authorizations of $840 million for a system of development highways and access roads which will open up the region for industry and tourism and widen the horizons of the population; $147 million for health, vocational education, farming, mine area restoration, and other new projects; and $90 million to supplement funds available to local communities under existing Federal grant-in-aid programs. Additional funds will be made available under other existing programs to accelerate development in the region. These measures, carried out with strong participation of State and local governments, should, over a period, serve to bring Appalachia and its people closer to the level of economic well-being of the rest of the country.

### ADJUSTMENT ASSISTANCE TO PREVENT AREA DECLINE

Both the regional recovery and Appalachia programs deal with deep-seated economic maladjustments that require the rejuvenation of an area or region. Areas do not become distressed overnight. They sink into that status through some specific decline of the economic base, frequently followed by inertia and stagnation, finally producing a closed circle of low incomes, low opportunities, poor schools, bad diets, departure of the most qualified young people, weak social structure, and finally, chronic poverty.

The time to head off this pattern of developments is at the first sign, the initial blow to the economic base. For this reason, there is increased interest in adjustment programs that will quickly put a threatened community on the road to recovery.

Frequently, the first sign of impending deterioration is the closing of a major plant. Each year, numerous plants close all over the United States, involving substantial layoffs of workers. Usually, a single plant is a small part of the economic base, in which case there is little hazard of area depression. But in some cases the plant is large in relation to the community, and in a few cases it is the major employer.

Some of these cases occur as a result of changing defense expenditures or the shutting down of Government installations. Both the Defense Department's Office of Economic Adjustment and the Atomic Energy Commission's Office of Economic Impact and Conversion have helped communities and firms to meet changes which may involve reconversion of firms to new products, recruitment of new employers, and finding alternative employment opportunities for laid-off workers. The President's interagency Committee on the Economic Impact of Defense and Disarmament is currently preparing a comprehensive report on this subject.

The Trade Expansion Act provides for technical and financial assistance for firms in cases where disruptions are directly attributable to competition from imports. Special aid is also given to employees in the form of trade adjustment allowances (extended unemployment compensation), relocation allowances, and training. These provisions need to be more fully implemented in the years to come.

The recently formed President Task Force on Community Assistance is designed to provide aid in cases of local economic distress caused by large-scale layoffs. Growing out of the Government's successful ad hoc program to aid South Bend, Indiana, after a major plant closing, the Task Force has since provided assistance to Lisbon Falls, Maine, and is currently studying other communities where it might be of assistance. If the threatened unemployment is substantial and the impact can be anticipated, it would be preferable to take remedial actions before major layoffs occur. Advance designation for aid under regional recovery programs would be a useful step.

For cases arising out of technological change, the Congress has charged the National Commission on Technology, Automation and Economic Progress to explore public and private means "to facilitate occupational adjustment and geographical mobility, and to share the costs and help prevent and alleviate the adverse impact of change on displaced workers."

## EFFICIENCY IN GOVERNMENT

Governments, Federal, State, and local, account for 21 percent of our production, of which the Federal share is about half. Flexibility and efficiency in the private sector are, for the most part, assured by market forces; efficiency in Government requires constant reassessment of the value and costs of public programs.

*Minimizing costs.* Many of the methods of increasing productivity and reducing costs in the private sector, such as improved management procedures and the adoption of modern technology, have made possible similar gains in Government. The use of electronic data processing equipment, as in the Internal Revenue Service, and of management training programs, as in the General Services Administration, can raise efficiency in these Government agencies, just as they have in large private firms.

The Administration has placed major emphasis on measures to increase Government efficiency. Over-all responsibility for encouraging improved organization and management in the executive branch of the Government rests with the Bureau of the Budget. In 1964, it completed a major study of ways to measure productivity in Government organizations.

Gains in efficiency have been particularly great in the defense program during the last four years. They have been assisted by cost-effectiveness studies, using modern analytical techniques of decision making to discover least cost solutions and weigh costs of programs against their alternatives.

*Public civilian investment.* A large part of our public expenditure is devoted to durable physical assets which contribute, over time, to productivity in public and private civilian activities. In fiscal year 1965, Federal Government expenditures for civilian public works will be about $7.8 billion.

Federal investment expenditures should only be undertaken if they yield a good social return. The use of carefully drawn economic evaluation criteria can help to assure, at least in some fields, that public investment yields a social payoff as great as the resources could yield in the private sector. The longevity of dams, roads, and other kinds of public capital requires that decisions regarding outlays be based on careful forecasts of events in the distant future. And to assure the best use of capital within the public sector, the economic criteria must be uniformly applied.

*Pricing of public services.* Most public services—such as defense—are provided for society as a whole. However, certain public services—particularly in transportation, communications, and water resources—are provided for identifiable groups or for individuals. Whenever beneficiaries can be identified meaningfully, fair prices and user fees can encourage efficient use of Government-supplied goods and services and preserve equity among various groups in the economy.

The next chapter discusses several outstanding tasks of public policy. These will require increasing investment of resources in the coming years. If these tasks are to be carried out, existing programs must be carefully reviewed to assure that they are conducted without waste, at minimum cost, and that obsolete activities are cut back or abandoned. Further, the new programs must be designed to accomplish their goals effectively with the least necessary outlay of resources.

The public tasks ahead are of such scope that only an efficient Government, conscious of its responsibility to the taxpayers, and relentlessly pursuing every path to lower costs and increased productivity in Government, can hope to achieve success. It is therefore doubly important to promote efficiency in Government.

## Chapter 4

# Some Economic Tasks of the Great Society

THE UNITED STATES has long been a rich country. The abundance of our material output is one of the wonders of the world. Our per capita income is greater by half than that of the advanced countries of Western Europe and many times that of the less developed countries which contain 2 billion of the world's 3 billion people.

Yet we know that our society is imperfect. The President has sounded the keynote for a new effort to address ourselves to social problems which have been in our consciousness but which we have failed to attack with the full use of the great technical, social, and economic resources that we possess.

World War II, and the long cold war diverted our effort to other matters. We have been too preoccupied to take a careful look at our society to assess the changes that have taken place and the new opportunities that have developed.

Today, we have grown accustomed to the ceaseless burdens of being a great power, of preserving nuclear superiority and holding the line around the perimeter of the Western World.

The trauma of the Great Depression has healed as our economic system has shown its ability to avoid depression and, for the last few years, even recession. The steady expansion of output and employment—with remarkable price stability—has raised our sights, leading us to demand more of our economic system.

The role of the Federal Government changed in the New Deal of the 1930's and in World War II. The Government accepted responsibility for assuring a minimum of economic well-being for most individuals, for many special groups, industries, and agriculture. It undertook the task of stabilizing the economy against the destructive power of the business cycle, and it developed more active policies for resource development, transportation, business regulation, and labor relations. Its defense program made it the biggest purchaser in the economy.

After years of ideological controversy, we have grown used to the new relationships among Government, households, business, labor, and agriculture. The tired slogans that made constructive discourse difficult have lost their meaning for most Americans.

It has become abundantly clear that our society wants neither to turn backward the clock of history nor to discuss our present problems in a doctrinaire or partisan spirit.

We are ready to take a large step forward, to put on the agenda tasks long undone, to use our creative powers to build a better America—to move toward the Great Society.

The initial agenda for the Great Society does not lie solely in the realm of economics, though most of it has an economic dimension. It looks toward development of our human resources, preservation and improvement of the environment in which we live and work, and it dedicates itself to advancing the well-being of the individual.

In earlier chapters, policies to create an economic foundation for these goals have been discussed. The present chapter considers the following tasks:

—meeting the challenge of urbanization;

—educating our citizens for a complex world;

—raising health standards for all Americans;

—reducing poverty; and

—assuring equality of opportunity.

The following material is designed to present factual background and analytical insights into the economic aspects of these tasks and their achievement.

## URBANIZATION OF OUR SOCIETY

Today, America is an urban nation. In 1960, 125 million people, 70 percent of our population, lived in urban places—places with a population of 2,500 or more. Half a century earlier, less than half of our people resided in urban areas (Chart 15). And the forces promoting urbanization are not likely to abate. By the year 2000 over 250 million people, 4 out of 5 of the population, are likely to be urban.

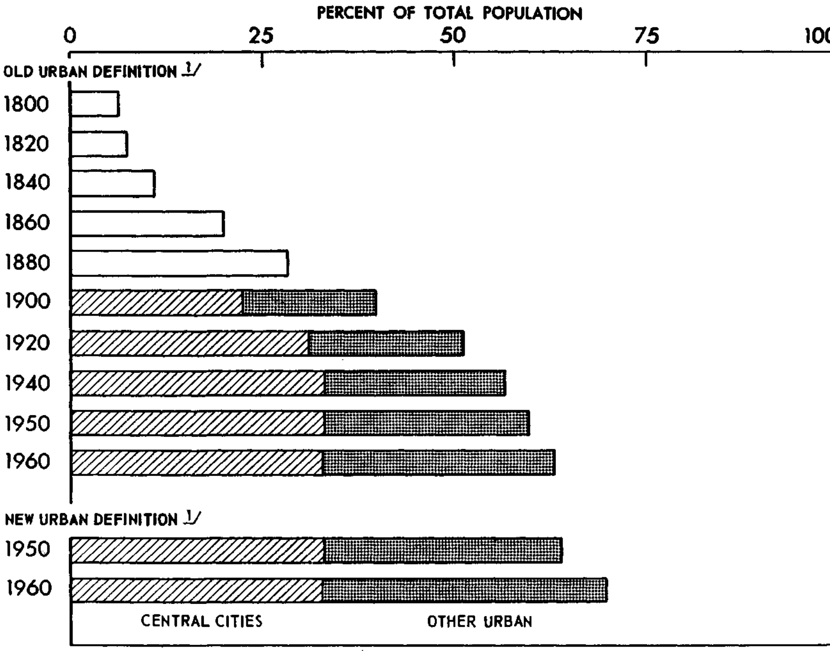
Moreover, the urban population is increasingly concentrated in metropolitan areas—clusters of cities and suburbs and their nearby hinterlands. New York, the largest, had 10.7 million people in 1960. Altogether, one-third of the U.S. population lived in 24 metropolitan areas containing a million or more people. Another 30 percent lived in the remaining 188 metropolitan areas. But 10 million of the urban population still live in the smaller towns that are not part of metropolitan areas.

The urbanization of our society has been greatly accelerated by immigration from abroad and migration from farm to city. Most of the European emigrants to this country poured into the rapidly growing cities of the late 19th and early 20th centuries. This population movement came to an abrupt halt with World War I and the subsequent introduction of immigration quotas.

As the great immigrations from abroad reached their peaks and receded, an equally massive internal migration from rural to urban areas began. In many ways it has produced social and economic effects as far-reaching as the earlier waves of immigration.

Chart 15

## Urban Population in Relation to Total Population




1/ FOR DEFINITION OF URBAN, SEE DEPARTMENT OF COMMERCE, BUREAU OF THE CENSUS, 1960 CENSUS OF POPULATION, VOLUME I, PART 1.

SOURCE: DEPARTMENT OF COMMERCE

Although the movement of people from the land to the cities is not new, it has reached new proportions in recent years. Indeed, the size of this internal migration is not generally appreciated: over 1 million a year have left the farm since 1940. A minority of the migrating farm families have found new opportunities in rural communities. The vast majority have sought new jobs in urban areas. And others besides farmers have left rural areas, bringing the total influx to the urban areas of 25 million.

Finally, the high birthrates of the postwar period have contributed as much to the absolute growth of urban populations in the last two decades as has the migration of people from rural areas.

### CHANGING STRUCTURE OF URBAN AREAS

The rapid growth of population in our metropolitan areas has been accompanied by major changes in the locational patterns of life and work. The growth of cities has long taken place primarily by outward movement at the fringes. During the postwar period this process has been characterized by its speed and its tendency to take place beyond the boundaries of central cities. Between 1940 and 1960, the share of the metropolitan population living in central cities fell from 63 percent to 51 percent; the population of central cities rose by only 12 million, while the metropolitan population outside central cities rose by 28 million. Between 1950 and 1960, the central cities of 14 of our 15 largest metropolitan areas lost population.

The flight to the suburbs has been motivated by a desire for more space, fresh air, and privacy, and by a desire to escape from the social disorganization of the city. It has been facilitated by high postwar incomes, by the ready availability of federally guaranteed mortgage credit, and by the automobile.

Many businesses also have been moving from central cities. Retail businesses and, to a lesser extent, wholesale businesses have followed the population to the suburbs. Manufacturing industries have been growing much faster in the suburbs. By 1960, half of the jobs in manufacturing in metropolitan areas were outside the central cities.

A major reason for the migration of manufacturing industries is their desire for space. Expansion is difficult and costly in the central city locations, and modern technology places a premium on continuous one-floor operation. The rise of trucking, and, in many instances, the decreasing dependence on bulky raw materials, have tended to free manufacturing industries from the need to locate near railroads, rivers, and harbors. More widespread ownership of cars by workers has also increased the flexibility of plant location.

There has been continued concentration in central cities of financial, legal, and specialized business and consumer services. Cultural and educational facilities, central office administration, and governments have also shown preference for expansion in central city locations.

By and large, the transformation from rural to urban and from urban to metropolitan areas has been consistent with the search for greater economic opportunity and higher economic rewards. Urban areas offer far more opportunities for high-paying jobs and urban people enjoy higher incomes. With some exceptions, our largest metropolitan areas rank near the top in this respect. But in the wake of this transformation have come serious problems of adjustment: for the rural areas, adjustment to decline; for the central cities, adjustment to change in population structure and economic base; and for the suburbs, adjustment to rapid growth.

## PROBLEMS AND UNMET NEEDS OF URBAN AREAS

Existing institutions have responded only partially to the rapid growth and changing economic structure of our large cities. Many public and private efforts are already devoted to our urban problems, but the time is ripe for a more comprehensive response.

Our concern is both with the disadvantaged in the city and with the quality of the physical environment. Some of the human problems—education, health, and poverty—are common to rural and urban areas; they will be discussed more generally later in this chapter.

*Human problems of the cities*

Rural-urban migration has created problems of adjustment for the migrants and for the areas receiving them. Existing urban educational systems, social groupings, and economic structures have been unable to absorb smoothly the rapid influx of the poor, uneducated, and unskilled among the rural migrants.

Many have found it difficult to adjust to the new economic and social environment. Because they lack skills, they are handicapped in an industrial society which is increasingly replacing unskilled labor with skilled labor and machines. They become victims of impersonal business fluctuations which affect most heavily the younger, the less skilled, and the nonwhite workers. And if unemployed, they cannot fall back for food and shelter on the extended family system of a traditional rural society.

As middle and upper income groups have fled to the suburbs, central cities have been left with a disproportionately large share of the poor. This situation has been aggravated by racial discrimination which often restricts nonwhites to the older neighborhoods of central cities.

Poverty, lack of education and skills, and irregular employment stifle incentives for self-improvement and lead to social disorganization. Family breakup, alcoholism, drug addiction, rising crime rates, and illegitimacy have become major problems in our cities. Children in such environments, left to their own resources at an early age, quickly assume the ways of the preceding generation, perpetuating the process of poverty. Society must pay the costs through waste of human resources, increased public welfare expenditures, and decay of our social fabric.

The human problems are aggravated by the inadequacies of the physical environment. The accommodation of a large population at very high densities in cities which were shaped in an earlier technological era produces living conditions with little privacy or amenity.

*Urban decay*

The blight and decay that afflict large parts of central cities are clear and visible. Part of what we see is another reflection of poverty: poor people cannot afford adequate, attractive housing. Another part results from the decreased dependence of industry and trade on central city locations.

But blight in cities tends to be cumulative. The older structures concentrated near the city center lose their economic usefulness as the functions of the downtown areas change. Extensive conversion, rehabilitation, and reconstruction are needed. If a few buildings need to be replaced or renovated in an otherwise prosperous area, the market provides private developers and builders with sufficient incentives to undertake the work. However, when a pattern of decay permeates a large area, the dilapidation of neighboring buildings reduces the profitability of improving a particular property. A large area must then be improved as a single unit, and the cost and difficulties of acquiring and redeveloping a large tract of central city land are likely to deter private investors from the undertaking. In such cases, there is need for public policies to assist the private market in developing property for new and improved uses.

Although inadequate housing is by no means the only aspect of urban blight, it is the most important. Ten percent of all urban households—about 3.8 million families—live in housing that is dilapidated or lacking such amenities as plumbing facilities, piped hot water, and kitchen or cooking equipment. Inadequate housing is particularly acute for nonwhites: only 7 percent of urban white families live in inadequate housing, compared with 32 percent of urban nonwhites.

In many U.S. cities, the process of urban blight is worsened by discrimination against nonwhites. Discrimination in housing markets provides a captive market for dilapidated slum dwellings. Large profits can be made by undermaintenance, since Negroes are virtually deprived of access to adequate housing. The situation is sometimes aggravated by inadequate enforcement of building codes and public health statutes. The success of any effort to upgrade urban housing standards will depend on the elimination of racial barriers.

Commercial and industrial structures also become obsolete. The failure to maintain these facilities reflects in part the greater attraction of suburban locations. Here, too, it is sometimes difficult for normal market processes to avoid cumulative deterioration, and achieve conversion to new uses.

### *Area-wide problems*

The large metropolitan area typically consists of a central city and several smaller suburban communities. In dealing with many of the public services of the metropolitan area, it is desirable to take a broad view encompassing the needs and preferences of all the constituent communities. This is true in some instances because there are important economies that can be achieved by acting in concert; in others, because decisions taken in isolation by a particular community may have undesirable side effects on its neighbors. Thus, as metropolitan areas grow in size and diversity there is greater need for some area-wide coordination and planning.

*Land use.* Efficient use and aesthetic development of the limited land resources are major problems facing almost all urban communities. Private uses compete with each other and with public facilities for space. Individual land use decisions affect the value of neighboring properties and the general environment. These effects can be given adequate weight only if a broader social view is taken, through appropriate taxation, zoning, and other regulations.

In metropolitan areas, zoning and other land use restrictions need to take into account the needs of the area as a whole, together with the special problems of the individual communities. Each community in isolation will zone its land use to suit itself, frequently banishing the less desirable uses to outskirts remote from its center and residential areas, but possibly near the living areas of neighboring communities. If the area is to have an efficient transportation system and if enough land is to be set aside for recreational purposes in convenient locations, a metropolitan perspective must be added to local land use decisions.

*Transportation.* The movement of people and businesses to the suburbs has greatly increased the burdens on our urban transportation systems. Part of this increase has been due to commercial traffic—the result of expanded economic activity. The greatest part, however, has been due to the growth of commuting between places of residence and employment. People are commuting longer distances, and more are crossing city boundaries. During the 1960 Census week, nearly one-fourth of the 39 million workers employed in our metropolitan areas commuted across the limits of the central city.

By no means all urban traffic moves into the city in the morning and out in the evening. As much as 29 percent of commuting across central city limits takes place in the opposite direction. The decentralization of retailing, manufacturing, recreation, and other activities has meant that travel patterns have increased in variety and complexity.

Commuters in most areas travel to and from work by automobile. This has led to massive investment in streets and highways and in parking facilities. As roads have been extended and improved, more individuals have been encouraged to commute by automobile, and congestion has continued. This has stimulated a revival of interest in mass transportation.

An effective transportation system involves a combination of individual and mass transit. The advantage of the automobile is its flexibility and convenience in terms of time and place of travel, number of people, and cargo. The advantage of public transit lies in its lower cost, more economical use of space, and broader availability to persons unable to rely on automobiles. But no one system can do the job alone.

In many areas, patronage of public transportation has declined drastically; between 1952 and 1962, revenue passengers carried by buses and streetcars in the United States dropped by 41 percent; and 194 transit companies were abandoned between 1954 and the end of 1963. The loss of patronage raises unit costs, requiring higher fares to break even, and leading to further shrinkage of patronage. Railroads subject to the same process have abandoned many commuter routes. With the advent of the automobile, some decline in patronage of public transportation was inevitable. Yet it might not have been as great under a program of more balanced public development of individual and mass transportation. While billions of public funds have been spent on roads and streets, the mass transit systems have not been able to attract private capital, nor have the central cities been able to invest sufficiently to keep them from deteriorating.

Clearly, the transportation problems of a metropolitan area transcend individual communities, whether they be the central city or the suburbs. An effective transportation system for the metropolis should permit people to move easily both between and within the suburbs and central city. Individual communities working in isolation to solve their local traffic problems are more likely to provide a patchwork than a logical system of connecting routes. Thus, area-wide planning is required if an effective transportation system is to be devised and coordinated.

*Waste disposal and water pollution.* The growth of urban population, commerce, and industry has led to a rapid rise in the use of water. Little water is actually consumed in most uses for which it is withdrawn. Most of it is returned to some natural body of water, usually with some waste or other deterioration in quality. If the quality has not deteriorated too much, the water is available for reuse. Water in major rivers is reused several times before it reaches the sea.

Since most of the costs of pollution are borne by downstream users rather than by those who generate the wastes, municipalities and industry have little incentive to treat waste adequately before discharge. The result is that the collection and treatment of waste lag behind water use. In 1962, about 20 million more people were served by municipal water supply than by waste treatment systems. Much industrial waste is discharged without treatment, and between 1950 and 1960 the discharge of industrial organic waste to streams increased by 30 percent.

The discharge of pollutants is concentrated in urban areas and is increasing as time passes. More effective regulations and enforcement will be necessary to achieve cleaner streams and lakes. Another policy instrument that may be of value is a system of fees for the discharge of effluent. Such fees, if feasible, would confront polluters with the social costs of their actions and would encourage them to reduce pollution.

*Air pollution.* Air pollution, like water pollution, results from excessive discharge of wastes, often the result of incomplete combustion. Pollutants are discharged into the air by industries, households, and municipalities. The automobile is probably the largest single source of air pollution; California has adopted a law prohibiting the sale of cars without pollution control devices, and other states are considering similar action.

Discharge of pollutants has increased rapidly with the growth of population and industry. More than half of all U.S. urban communities are affected by air pollution. One-quarter of the population live in communities in which air pollution is a major problem.

Air pollution is at best a public nuisance, at worst a source of serious damage to health and property. Although more research is needed, relatively inexpensive methods are already available for the control of most pollutants. As with water pollution, economic incentives are lacking. The cost of air pollution is borne mainly by the community at large rather than by those responsible for the pollution. It can be reduced by more effective regulation or, for major polluters, by discharge fees.

*Open spaces and outdoor recreation.* Although people value open spaces in urban areas, there is no market on which they can register these preferences. It would not be feasible to create such a market because of the difficulty of imputing or confining benefits from urban open spaces to particular individuals. There is a strong temptation for hard pressed local governments to maintain their tax base by abandoning open spaces to developers, by routing new roads through parks rather than through developed areas, and by making inadequate additions to the available open space as the population expands.

The amount of open space per person is small and probably declining in the larger metropolitan areas. In addition, the provision of State and county parks within driving distance of metropolitan areas is lagging behind the growth of these areas, and most of our Federal recreational facilities are remote from the major population centers.

But with incomes rising and leisure time increasing, the demand for outdoor recreation is growing rapidly. Many city parks are now used nearly to capacity, and visits to State parks have increased by 123 percent in the last decade. The Outdoor Recreation Resources Review Commission projects a tripling of over-all demand for outdoor recreation facilities by the year 2000.

### *Federal programs for urban areas*

During the past thirty years, the Federal Government has been developing programs of assistance—to individuals, to business, and to State and local governments—that contribute to the improvement of the urban environment and to the alleviation of the social, developmental, and financial problems of urban areas. Among the most important of the existing programs to improve the physical environment are aids to public housing, urban renewal, highways, mass transit, waste treatment, airports, and hospitals. The human problems of the city are approached through national programs for education, health, welfare, and social insurance, and to combat poverty.

These measures have made great contributions to the development of urban life. But the rapid growth of metropolitan areas has compounded or changed the nature of many of these problems and created new ones. New knowledge—partly gained from the mistakes of the past—can be brought to bear. It is now evident that new directions in Federal policy are needed in these efforts.

Most important is Federal encouragement of area-wide metropolitan planning, to assure the development of integrated systems of land use, of transportation, water supply, sanitation, and pollution control. Some Federal programs now require local coordination in the provision of physical facilities. But even if some area-wide coordination is achieved in individual functions such as transportation or sanitation, an effectively integrated pattern of development cannot emerge unless the several functions are brought into a common focus. This can only be achieved if there is some method of taking an area-wide, comprehensive point of view, which brings together all levels of government and pertinent private organizations to evolve a metropolitan area plan.

Metropolitan area planning is no panacea. Each community has its own preferences and problems, and its local government is best able to discern them. Nor does metropolitan planning directly augment the resources available to meet the rapidly increasing needs. It is clear, however, that fragmentation of legal jurisdictions has proceeded too far in many of our metropolitan areas. The Federal Government has a responsibility to promote planning to assure that public needs are met efficiently and that the federally aided local public programs will, indeed, produce a more livable and efficient urban environment.

Because the allocation of land to various purposes is so fundamental to the future pattern of a metropolitan area, the Federal Government should continue to give some help to promote better land use planning. While decisions about land use will remain mainly a local matter, research and the spreading of information to improve zoning techniques are desirable.

As the metropolis grows in area and density, it is particularly difficult to preserve open spaces for recreational and aesthetic purposes. The Federal Government already aids localities to acquire open lands, and this program is a logical part of a greater emphasis on metropolitan planning.

One way of avoiding congestion in the metropolitan area is to bring homes, community services, and jobs closer together in smaller and more self-contained communities. Federal aids to urban areas need to be adapted to this promising new approach.

The Federal Government has a responsibility to reexamine and improve its existing programs. Urban renewal is rapidly transforming many of the blighted downtown areas of our cities to new and more productive uses, thereby helping to reverse the downward spiral of malfunction and decay. However, despite an increase in the efforts to find adequate housing for the persons displaced by the tearing down of slums, it is evident that these efforts are still not wholly successful. Experience has shown that much of the land made available through urban renewal in downtown areas is drawn into commercial and high rent residential uses. The Government therefore must take further steps to augment the supply of low and medium rent housing in the city. The recent emphasis in urban renewal on rehabilitation of existing residential units should make a contribution to this need; and the Federal sharing of costs of code enforcement begun last year should help to stem the decline of gray areas.

The FHA and VA mortgage guarantee programs have greatly increased the supply of middle-income houses and are among the main forces behind the growth of suburbs. The public housing program has sought to provide low-income housing, and in recent years housing assistance for middle-income families has been a major program innovation. But we need to test out more flexible methods of providing housing assistance for families of different incomes, under which families are not forced to move out of their homes when their incomes rise above a specified level.

The impact of governments on the private decisions which mainly determine the development of metropolitan areas is large. The value of land in alternative uses depends on government decisions on zoning and transportation. The commuter's decision to use a particular transportation system depends on the cost he must pay. The extent of air and water pollution depends on the willingness of governments to impose regulations. Federal, State, and local methods of taxation help to determine the profitability of slums and of their rehabilitation.

As public policy seeks to improve the livability of metropolitan areas, it must be keenly aware of its effects on private incentives and behavior. The development of our metropolitan areas will always be primarily determined by private actions. Wise government policies will promote private efforts that improve the quality of urban life and will provide incentives which channel private decisions toward an efficient use of resources.

## PROBLEMS AND UNMET NEEDS OF RURAL AREAS

Farming has traditionally been the primary, if not the exclusive, industry of rural areas. Today, only a quarter of the rural population lives on farms. Farming has become a shrinking source of employment opportunity for the rural labor force. The industrial revolution in agriculture in recent decades has raised gross output per man-hour on the farm to nearly 4 times what it was in 1940. In the process, farming has been transformed from a way of life into a business; farms have grown larger and declined in number. Less than one in ten of the youth now on farms can expect to become farmers. The decline in farm employment opportunity and the resulting adjustment problem is intensified by economic growth itself. Inevitably, as our national income grows, a smaller proportion is spent for the products of agriculture.

Although other sources of employment—mainly in rural service industries—have expanded somewhat, they fail by a wide margin to compensate for the heavy losses in agriculture. Stagnation in rural employment opportunities has occurred at a time when economic opportunity in urban centers has been expanding. Response of rural people in this situation has frequently been migration. The rate at which people have migrated from agriculture is closely associated both with the rate at which over-all economic growth has created job opportunities elsewhere and with changes in the productivity of agriculture that have reduced the number of farm jobs. Thus, there is an economic push as well as a pull that operates upon the size of the rural-urban migration and alleviates or compounds the pressures of excess labor supply on rural communities.

As the economic opportunity in agriculture for new labor market entrants has fallen in most rural communities, little has taken its place. The economic vitality of many rural areas has declined and economic growth has faltered. In some places, commuting to industrial jobs has filled the void. But many communities have suffered major population losses. In about half of the Nation's 3,081 counties the total population declined during the 1950's, and more than 90 percent of those losing population were rural counties. Thus, at a time when the larger urban communities are faced with the problems associated with rapid growth of population, many rural communities are confronted with the dilemmas posed by rapid loss.

This loss has mainly been of young people, leaving behind an aging rural population. A decline of a rural community's population by as little as 5–10 percent in a decade usually means that there has been a net outmigration of more than 50 percent of the young adults.

The average rural community does not now do as well as the typical urban community in providing education, health, and other necessary community services. This deficiency is compounded in many communities which have lost so many people that schools, churches, stores, and even local governments can no longer be adequately supported. As the economic base of the community is impaired, the supply and, particularly, the quality of the community's social services decline even further. The only way out of this problem, short of a major new source of economic activity and employment, is for such communities to search for and cooperate in the creation of centralized institutions serving wider areas—such as has occurred in the consolidation of schools, and even county governments in some cases.

The problems of urban areas have their counterparts in small towns and rural communities. Poverty, inequality of opportunity, and inadequate health and educational facilities have an even higher incidence in rural than in urban areas. These problems are essentially national in scope, and they are presented in the following sections in their national framework.

## EDUCATION

The education of our people is the most basic resource of our society. Education equips man to think rationally and creatively in his quest for knowledge, for beauty, and for the full life; it provides the basis for effective political democracy; and it is the most important force behind economic growth, by advancing technology and raising the productivity of workers.

This country has led the way in making education available to all. It has the highest level of educational attainment and allocates almost 6 percent of its gross national product to direct expenditures on education.

In the last seven years, since the launching of the first sputnik, there has been a great concern about both the quantity and the quality of American education. Major efforts were made to strengthen education for science and technology, including the National Defense Education Act of 1958. In 1963 and 1964, major Federal programs were enacted to aid higher education through grants and loans, to improve and expand facilities for the sharply rising numbers of students about to reach college age, to support teacher training and language study, and to strengthen vocational education.

Most recently, the drive for improvement has focused on meeting the educational needs of disadvantaged groups, to equip them to escape from poverty and to become full participants in our productive effort and standard of living. The President has proposed a new program to help education this year aimed primarily—though not exclusively—at this effort.

## RETURNS TO EDUCATION

The impact of education on economic productivity, though long recognized, has recently come to be more widely appreciated. Expenditures on education produce a wide and important array of direct and indirect economic benefits to individuals and to society.

Evidence on the effects of education on productivity is mounting. Increases in the conventional inputs of labor and capital explain only about half the growth of output in the economy over the past half-century. The rising level of education appears to account for between one-quarter and one-half of the otherwise unexplained growth of output. Despite the great expansion of the better-educated population, the pattern of income differentials associated with education has remained substantially unchanged over the past quarter-century. In 1963 the median income of male high school graduates 25 years of age and over was $6,000, compared with $5,153 for those with 1–3 years of high school and only $4,076 for elementary school graduates. Moreover, the incidence of poverty is closely related to educational attainment—the chance that families headed by elementary school graduates will be poor is over twice as great as for families headed by high school graduates.

Other effects defy both easy cataloging and quantification. They include the impact of education on research and the development of new products and processes, and the economic efficiencies that result from general literacy and substantial educational attainment.

The direct and indirect benefits to society exceed those to individuals or specific communities. The operation of the market frequently makes it impossible for the individual to capture all of the gains produced by his work; the successful inventor, scientist, or artist creates benefits to society not measured by their financial reward. And communities which lose some of their better educated young people—as many rural communities are doing—are unable to reap the benefits of increased productivity which their investment in the education of those leaving makes possible. The presence of these public benefits warrants a social investment in education above and beyond what the single individual or his family or his area might be prepared to spend, and argues that the Federal Government should assist the efforts of States and localities.

Even when viewed in the narrow perspective of economic benefit alone, expenditures on education yield high rates of return. The rate of return to society on its total expenditure for the public and private education of males is estimated at more than 10 percent at both the high school and college levels; this rate compares favorably with the return on other investment opportunities in the economy.

## AVAILABILITY OF EDUCATION

The quality and availability of education vary greatly. For example, in 1961–62 current expenditures per child in average daily school attendance were $438 in the Great Lakes and Plains States, compared with $295 in the Southeast. Differences in teachers' salaries alone cannot account for such variations. Differences in fiscal resources are resulting in differences in quality of education.

In 1964, about 40 percent of the total population over age 25 in the South had completed high school; in the Nation as a whole, almost half of the total population had a high school education. Nonwhite males over age 25 averaged 8.7 years of schooling, compared with 11.9 years for white males. Although these differences are narrowing among the young, they are still large. Even in the age group 25–29, only 6 percent of nonwhite males have completed 4 or more years of college; the equivalent figure for white males is 18 percent. Moreover, the education available to Negroes has been inferior in many cases.

Increasing the resources devoted to education will help to eliminate the disparities in the amount and quality of education offered in different sections of the Nation and to different segments of the population. In addition to making education available, it is necessary to insure that low family incomes do not bar individuals from taking full advantage of these expanded opportunities. Many individuals fail to develop their talents fully, often for economic reasons. In 1960, one-third of the top 25 percent of youths did not go on to college; 5 percent did not even finish high school. This is a serious waste of talent.

The quality of our education must be continuously improved. Many school systems are already adopting strengthened curricula, and demonstration and experimental programs are being evaluated. But increased support is needed for innovation, adaptation, and the speedy dissemination of new research.

## THE PRESIDENT'S PROGRAM FOR EDUCATION

In his Education Message, the President has recommended a program that will broaden the scope of the educational system, will make educational opportunities more equal, and will raise the quality of education at all levels.

The major proposal for equalizing and expanding educational opportunity is a $1 billion program to aid elementary and secondary schools to improve the education of the poor. This program will supplement by 50 percent the resources devoted to educating the children from families with incomes below $2,000. It will contribute greatly to the resources of poor school districts—as much as 30 percent beyond present expenditures in the very poorest areas and 3–10 percent of total operating costs in the larger cities. A program of preschool training under the Community Action Program of the Office of Economic Opportunity will enable children from low-income families to take better advantage of elementary and secondary education.

To increase the quality of education, the President has recommended the establishment of a new program of grants for supplementary educational centers to be set up by a consortium of schools and other agencies in a community. They will provide special services—advanced science courses and laboratories, remedial reading, television instruction, summer courses, after school help, music and language training, and other types of aid—for all of the participating schools, public and private. In addition, proposals have been made for strengthening educational research and innovation, library resources, and State departments of education.

A new program will seek to identify, early in their high school career, students of the greatest promise and the greatest need. It will provide scholarships to encourage them to decide in favor of higher education in order to develop their talents. Low-interest loans and an expanded Work Study Program will help college students continue their studies.

The President has proposed a program for strengthening smaller and less developed colleges through exchange arrangements with large universities. College libraries will be enriched by a grant program for the purchase of books, and universities through their extension services will be encouraged to tackle problems of the city.

## HEALTH

Medical knowledge and treatment have advanced rapidly over the past several decades. Unfortunately, these gains have not been fully reflected in the health of the population. New knowledge is not being disseminated widely or quickly enough; trained manpower and special facilities needed to translate new treatment techniques into medical practice remain inadequate; and many individuals are financially unable to take advantage of even generally available health services. It was to these problems that the President addressed his Health Message to Congress.

### THE STATE OF OUR NATION'S HEALTH

Improvements in health in this century have been remarkable. Between 1900 and 1963, the death rate dropped from 17.2 to 9.8 per 1,000 population; as a consequence, life expectancy rose from 47 years to 70 years. At the same time, there were substantial declines in morbidity as infectious and parasitic diseases were eliminated by public health measures, new drugs, and improved living standards. Despite these advances, life expectancy in the United States is below that in several countries, and ten countries have lower infant mortality rates.

Chronic diseases remain as the major causes of mortality and disability. The recent Report of the President's Commission on Heart Disease, Cancer and Stroke predicted that these three diseases alone will take almost 1½ million American lives this year. Wider use of available knowledge could save the lives of approximately 150,000 cancer patients each year, and better detection methods and more extensive use of surgical techniques could save many others who suffer from heart disease and stroke. But elimination of these diseases and a further lengthening of the average lifespan require future breakthroughs in medical research.

This year, total funds supporting medical research will approximate $1.7 billion, over $1 billion of which comes from Federal sources. Important new discoveries have emerged from this unparalleled research effort. With the development of vaccines, for example, polio has been virtually eliminated in the past decade. The discovery of new antibiotics has reduced both mortality and the amount of illness. And medical research efforts have produced improved methods of disease detection and better surgical techniques. For example, children with acute leukemia now have a much longer life expectancy as a result of federally supported and conducted research.

To reap the full benefit of this scientific progress, new knowledge must be disseminated widely and quickly among practicing health personnel. The latest medical equipment, much of it complex and expensive, must be available throughout the country. And the public must have both the economic means and the understanding to seek and obtain early diagnosis and treatment. The failure to achieve these goals has been particularly unfortunate for children, the poor, and the elderly.

Better health services for children can contribute substantially to their future physical and economic well-being. Too many children—and especially poor children—suffer from chronic ailments or are handicapped, mentally retarded, or emotionally disturbed. The 15 million children of low-income families receive far less medical care than they require. They visit physicians only half as often as children from other families; more than half between the ages of 5 and 14 have never been to a dentist; and though they are hospitalized less, the duration of their stay averages twice that of children from higher-income families. Problems of child health frequently stem from inadequate maternal care which gives rise to birth defects, acute and chronic illnesses, and lasting disabilities.

Older persons, who tend to have lower incomes, larger medical costs, and a higher incidence of major and catastrophic illnesses, probably suffer most from insufficient health care. In 1962 only half of the elderly had any health insurance coverage, much of it inadequate. Median medical care costs for aged couples were $240; for a quarter of them, costs exceeded $500. Since their median income was $2,875, the average aged couple spent almost 10 percent of its already low income on medical care.

HEALTH PROGRAMS

To speed the application of existing knowledge and the development of new knowledge of diseases and their treatment, the President has proposed establishing a network of regional medical complexes. Combining medical research, medical education, and medical care, these centers will make available the best in diagnosis and treatment to people throughout the country. Additional support for basic research also has been proposed.

Enactment of hospital insurance for the aged under Social Security, financed by a separate trust fund, will improve health services for the elderly by helping to pay for inpatient hospital care, extended nursing home care, home health visits, and outpatient diagnostic services. The recommended program for child health, and more adequate public assistance grants for the medical expenses of needy children, will make an important contribution toward breaking the circle of poverty. Finally, the President has recommended expansion of programs in the field of mental health and mental retardation.

The extension of adequate health care to the entire population will require the growth of our health facilities and personnel. The Hill-Burton Act of 1946 has greatly aided hospital construction, and the 1964 amendments will provide further stimulus to the construction and modernization of medical and public health centers. The Nurses Training Act of 1964 and the Health Professions Educational Assistance Act of 1963 will augment the supply of medical manpower. In addition, the President has recommended direct financial assistance to medical and dental schools to speed the flow of trained manpower to meet the rising demand for health services.

## POVERTY

Too many of our citizens neither share adequately in the benefits of our economic progress nor contribute effectively to its creation. America's renewed focus on poverty last year called attention to the fact that 35 million Americans—one-fifth of the population—still lived in poverty. When the President declared war against poverty in his State of the Union Message a year ago, the conscience of the American people was stirred.

Widening participation in prosperity will not be accomplished easily. It calls for a combination of public and private policies which, while reflecting society's compassion and concern, will attack the root causes of poverty. It requires assisting all citizens who need help in developing their full potential. It requires strengthening our protections against the economic hazards inherent in modern society. And it requires improving our assistance to those who, because of age, disability, or adversity, are unable to provide for themselves.

Last year, the Council's Annual Report set forth a preliminary analysis of the structure of poverty, focusing on the economic characteristics of the poor and the causes of their poverty. Since then additional information has become available, shedding more light on the process by which family poverty may arise, persist, or disappear.

## THE RECORD OF PROGRESS AGAINST POVERTY

The percentage of American families with incomes (in 1962 prices) below $3,000 fell from 32 percent in 1947 to 20 percent in 1962 and to 19 percent in 1963. Experience indicates that in periods of strong economic expansion the incidence of poverty declines. Between 1947 and 1962 the number of poor families fell from 11.9 million to 9.3 million; in 1963 alone it dropped an additional 300,000, and a further reduction probably occurred last year. The composition of this group of families showed little change from 1962 to 1963. The incidence of poverty remained highest among farm families, nonwhite families, and those headed by females, and among the elderly, the least educated, and those unable to work. The median money income of poor families has remained close to $1,800 since 1958.

## MEASURES AND CHARACTERISTICS OF POVERTY

In its 1964 Annual Report, the Council proposed an income below $3,000 as a test of family poverty. It recognized that a determination of poverty status cannot be exact, either conceptually or in practice, for "there is no precise way to measure the number of families who do not have the resources to provide minimum satisfaction of their *own* particular needs." However, the attack on poverty requires a quantitative perspective on the problem. Therefore, the Council concluded that the $3,000 income limit "provides a valid benchmark for assessing the dimensions of the task of eliminating poverty, setting the broad goals of policy, and measuring our past and future progress toward their achievement."

In the past year, additional research has been devoted to measuring the character and extent of poverty, taking into account a broader range of considerations than annual income alone. This will permit the development of more comprehensive measures of the problem.

### *Differences in family composition*

The $3,000 poverty line was intended to reflect the minimum current income needs of a typical family—typical with respect to size, age of members, and a variety of other characteristics. Recognizing that few families are typical, the Social Security Administration has now estimated the income needed to achieve comparable minimum standards of consumption by families of various size and age composition in both rural and urban areas.

The minimum income needs of an urban family of six, for example, will normally differ from those of an elderly rural couple.

Under these revised estimates, roughly the same total number of persons are classified poor as under the simpler $3,000 family income test, but the composition of the poverty group is somewhat different. The number of poor families is smaller; the number of adults is reduced, especially among the aged and those who do not work. The number of large families classified as poor increases, however; and, most important, the estimated number of children in poverty rises by more than one-third, from 11 million to 15 million. This means that one-fourth of the Nation's children live in families that are poor. These findings underscore the importance of helping young people escape from poverty. This pressing objective, stressed in last year's Annual Report, is emphasized in the Economic Opportunity Act and in the President's new proposals for education and health care of children.

*Asset ownership*

A family's ability to maintain an adequate standard of living depends on its accumulation of assets and liabilities as well as current income. A family may be able to sustain its consumption during an occasional year of low income by drawing down savings, borrowing on assets, and postponing the replacement of durable goods. Thus the measurement of poverty is improved by distinguishing temporary from chronic inadequacy of income, and considering the asset holdings of low-income families. However, in practice, few low-income families can long maintain satisfactory consumption levels by drawing down their assets. Average (median) net asset holdings of poor families amounted to only $2,760 at the end of 1962. The bulk of these assets consisted of equity in a home and thus could not be easily converted into consumption. Even if a typical poor family were to draw down its assets to supplement current income in order to maintain consumption at the rate of $3,000 a year, these assets would be entirely exhausted within two to three years.

Older families with incomes of less than $3,000 generally possess more assets than do younger families with low incomes. Many of the former are retired and are using their savings to meet living costs. A composite measure of poverty based upon income and asset criteria would exclude some older families now classified as poor under the income test alone.

*Income variability and the persistence of poverty*

The extent of chronic poverty is reflected by a measure of persistence—the percentage of poor families in any given year who remain poor in succeeding years. A study of incomes of the same families in two successive years shows that approximately 70 percent with incomes below $3,000 in one year have similarly low incomes in the following year. This suggests that the poor include a largely unchanging group of families. Persistence of poverty is greatest among families headed by females, the less educated, nonwhites, and the aged, as shown in Table 19.

TABLE 19.—*Persistence of poverty, by selected family characteristics, 1962–63*

| Selected characteristic | Persistence of poverty |
|---|---|
| All families | 69 |
| Age of head: | |
| 14–24 years | 62 |
| 25–34 years | 55 |
| 35–44 years | 53 |
| 45–54 years | 63 |
| 55–64 years | 71 |
| 65 years and over | 80 |
| Work experience of head: | |
| Worked | 60 |
| At full-time jobs | 53 |
| At full-year jobs [1] | 51 |
| At part-time jobs | 79 |
| Did not work | 83 |
| Education of head: | |
| Less than 8 years | 79 |
| 8 years | 72 |
| 9–11 years | 64 |
| 12 years | 53 |
| 13–15 years | 54 |
| 16 years or more | 40 |
| Type of family: | |
| Husband-wife | 68 |
| Wife in paid labor force | 48 |
| Wife not in paid labor force | 73 |
| Other male head | 61 |
| Female head | 76 |
| Color of head: | |
| White | 67 |
| Nonwhite | 76 |

[1] Worked 50–52 weeks.

NOTE.—Data relate to families and exclude unrelated individuals. Poverty is defined to include all families with total money income of less than $3,000; these are also referred to as poor families. Persistence of poverty is measured by the percent of poor families in 1962 that are also poor in 1963.

Data based on sample of families living at same address as year earlier; movers, whose characteristics could differ from nonmovers, are excluded. In addition, implied changes based on two interviews a year apart for the same family are particularly affected by response errors.

Data are not entirely comparable to those shown in Table 20. See note to that Table.

Source: Department of Commerce.

Temporary poverty is likely to arise from unemployment, illness, or other disability, and, for the self-employed, from the hazards of small business. Movement out of poverty is related to changing levels of economic activity.

The process by which over-all poverty is reduced from one year to the next involves a number of divergent influences. Some families become poor, a slightly larger number become better off, but the great majority simply remain poor. Of the 9.3 million poor families in 1962, 0.6 million were dissolved in 1963, and another 1.8 million—only 19 percent of the total—moved to a higher income status. Meanwhile 6.9 million remained poor (Table 20) and 1.7 million other families fell into the low-income group.

Of those families leaving poverty in 1963, slightly over two-fifths secured incomes between $3,000 and $4,000, one-fifth moved into the $4,000 to $5,000 range, and the remaining two-fifths reached or surpassed $5,000.

TABLE 20.—*Changes in poverty, 1962–63*

| Poverty status of family | Estmated number of poor families (millions) |
|---|---|
| Poor families in 1962 | 9.3 |
| Less: Families no longer poor in 1963 | 1.8 |
| Poor families dissolved in 1963 | .6 |
| Equals: Families poor in 1962 and 1963 | 6.9 |
| Plus: Families who became poor in 1963 | 1.7 |
| Newly formed poor families in 1963 | .4 |
| Equals: Poor families in 1963 [1] | 9.0 |

[1] Families with total money income of less than $3,000 (1962 prices).

NOTE.—Data relate to families and exclude unrelated individuals. Poor families are defined as all families with total money income of less than $3,000.

This table is based on total number of poor families that moved or were dissolved. The persistence rate—74 percent—derived from this table is somewhat higher than that in Table 19.

Source: Council of Economic Advisers.

Those families whose incomes rose from less than $3,000 to $5,000 or more undoubtedly included a large number of families where bread winners returned to full-time work or a new earner found a job. On the other hand, many of those who rose from poverty status, particularly those in the $3,000 to $4,000 bracket in 1963, probably did so only temporarily.

The statistics suggesting that about 20 percent of the poverty-stricken families in any given year are no longer poor in the following year certainly overstate the degree of real improvement in the income position of this group. They fail to reveal the extent to which many of these families hover about the $3,000 income line. An increase in income from $2,900 to $3,100 hardly constitutes an escape from poverty and, furthermore, may be quickly reversed. Therefore, some measure of poverty covering more than a one-year period is more appropriate and useful in identifying the incidence of chronic poverty. A poverty criterion based on a two-year income average of $3,000 yields nearly as many low-income families as is indicated by the one-year measure.

*Employment status*

The analysis of poverty in last year's Annual Report emphasized the importance of economic expansion and rising aggregate employment in reducing the number of poor families. But it also made clear that many of the poor—because their family heads are not in the labor force—do not necessarily benefit from general economic prosperity. Data on work experience in 1963, shown in Table 21, provide further indications of the relationship between unemployment and poverty.

Some 30 percent of families with incomes below $3,000 were headed by persons who held jobs (mostly full-time) throughout the year. An additional 14 percent were headed by persons in the labor force during only part of the year but who were never counted as unemployed because they moved into or out of the labor force. The heads of 16 percent of poor

TABLE 21.—*Distribution of all and poor families, by work experience of family head, 1963*

| Work experience of head | Percent distribution | |
|---|---|---|
| | All families | Poor families |
| Total | 100 | 100 |
| In labor force during year: | | |
| Employed all year | 67 | 30 |
| Employed part of year: | | |
| Not unemployed | 9 | 14 |
| Unemployed part of year [1] | 11 | 16 |
| Not in labor force during year | 13 | 39 |

[1] Includes small percent not employed at all during year.

NOTE.—Data relate to families and exclude unrelated individuals. Poor families are defined as all families with total money income of less than $3,000 (1962 prices).

Detail will not necessarily add to totals because of rounding.

Source: Department of Labor.

families experienced unemployment during 1963. The incidence of poverty was particularly high among those unemployed for long periods. A more prosperous economy and stronger job markets would have aided the incomes of all these groups, but particularly the last.

The largest group of poor families—39 percent of the total—was headed by persons completely out of the labor force during 1963. A few of these family heads, of course, are among "the hidden unemployed"—those employable workers who had withdrawn from or failed to enter the labor force because of discouragement about job opportunities. However, many more of them were retired, disabled, or were women with child-rearing responsibilities.

## THE ATTACK ON POVERTY

Passage of the Economic Opportunity Act of 1964 marked the opening of an enlarged attack on inadequate incomes in an economy of relative abundance. The main thrust of this effort is directed at the roots of poverty—particularly at helping the children of the poor. The programs of the Office of Economic Opportunity will provide a community-wide focus for anti-poverty efforts by offering education, training, and work experience to help young people escape from poverty. They augment other Government programs for education, training, health, and welfare services which deal less specifically with poverty.

Federal funds have begun to flow in support of Community Action Programs across the Nation. These Programs, planned, operated, and coordinated at the local level, will make services needed to break out of poverty available to the poor. The services can range from preschool preparation to counseling to establishing neighborhood centers. It is anticipated that Programs will be approved in approximately 300 communities this year. Community Action Programs, mobilizing local public and private leadership, are an important new social institution and a major weapon in the war on urban poverty.

The Neighborhood Youth Corps-Work Training Program will provide useful work experience opportunities for unemployed young men and women in State and local governments and nonprofit organizations. By the end of June, approximately 175,000 young men and women will have entered this Program. The Job Corps will offer education and vocational training—along with some work experience—in conservation camps and residential training centers to approximately 25,000 young people by this June. The goal of the Work Study Program is to provide part-time employment this year to nearly 100,000 low-income college students who need financial assistance to enter upon or continue their college educations. And the Work Experience Program will provide constructive work experience and training for close to 90,000 unemployed fathers and other needy persons.

The Federal budget for fiscal year 1966 provides $1.5 billion—almost twice the 1965 amount—in new obligational authority to the Office of Economic Opportunity to carry out these Programs.

Although several million people will be assisted by Community Action Programs this year, and over a half million more will participate directly in education, work, and training programs, this is only the beginning of the Nation's long-range war on poverty. Continuing effort, carried out with skill and imagination, will be required to eliminate poverty in the United States.

## EQUALITY OF OPPORTUNITY

Passage of the Civil Rights Act of 1964 marked the beginning of a new era of concern for equality of opportunity. This historic civil rights legislation outlaws a wide variety of discriminatory practices which have been applied against many groups, but particularly against Negroes.

The gains to be derived from new programs in the employment, urban, education, health, and poverty areas will be fully shared only if we continue breaking down the barrier of discrimination, whether because of race, creed, age, or sex.

The Civil Rights Act is likely to extend the horizons and motivations of nonwhite youth, as it opens up new employment opportunities. There will be greater incentive to stay in school and to obtain training. Incomes will rise and the circle of poverty in which many Negroes are trapped will be broken.

Discrimination against minorities—Negroes, Puerto Ricans, Spanish-Americans, Indians, and others—has significant economic and social costs. It is estimated that society loses up to $20 billion per year of potential production as a result of employment discrimination and poorer educational opportunities for nonwhites. They earn about 30 percent less than whites—even when they have received similar amounts (but often lower quality) of schooling and are in the same occupations. Not surprisingly, the incidence of poverty is much higher for nonwhites—40 percent, as against 16 percent for the white population.

The extent to which nonwhites fail to share in the economic benefits of a prosperous society—in housing, education, health, employment, and income—is revealed in Table 22. Such comparisons would be even more glaring were it not for recent efforts to break the barriers of job discrimination. The consequences of discrimination show up in low-income housing programs, in large welfare payments, and in a variety of special and remedial programs. These outlays attempt to make up for what society has failed to prevent.

TABLE 22.—*Selected measures of discrimination and inequality of opportunity, by race*

| Characteristic | White | Nonwhite |
|---|---|---|
| Housing, 1960: | | |
| Percent of families in substandard housing | 11.2 | 41.6 |
| Education, 1964: | | |
| Median years of school completed, 25 years of age and over | 12.0 | 8.9 |
| Percent completed high school, 20–24 years of age | 75 | 53 |
| Health, 1963: | | |
| Life expectancy at birth (years) | 71 | 64 |
| Infant mortality rate (per 1,000 live births) | 22 | 42 |
| Employment, 1964 (percent of total civilian employment):[1] | | |
| Professional-managerial occupations | 25.3 | 9.4 |
| Craftsmen and foremen occupations | 13.1 | 6.9 |
| Median income of males, 1963: | | |
| Some or completed college | $6,829 | $4,070 |
| High school graduates | $5,600 | $3,821 |

[1] Data relate to March 1964.

Sources: Department of Commerce and Department of Health, Education, and Welfare.

Efforts to eliminate discrimination in employment were heightened by the establishment in 1961 of the President's Committee on Equal Employment Opportunities. Discrimination in Federal employment and in the performance of Federal contracts has been prohibited. Government agencies, including the armed services, have intensified their efforts to widen job opportunities for Negroes.

The voluntary cooperation of businesses and unions has been enlisted to open both jobs and union membership to nonwhites. One of the most critical remaining barriers to the employment prospects of nonwhites is the lack of sufficient openings in apprenticeship programs. Until younger Negroes can acquire the skills necessary to compete in today's labor market, equality of opportunity will not be realized.

Discrimination is not limited to race. It is also applied against women and older citizens. Implementation of the Equal Pay Act which prohibits payments of differential wages to women when they are performing jobs similar to those performed by men promises to improve the earning power of American women. Widespread discrimination against the hiring of older people continues, though efforts have been made to offset this by retraining and increased placement activities for older workers.

The problems outlined above have long been with us. The programs that have been developed and the steps now proposed will not solve them overnight. But the steps we take now will help to determine the state of our society in the next generation and beyond.

By the year 2000, our population will exceed 300 million, four-fifths of them living in urban areas. If the average productivity gains until the year 2000 no more than match those of the last seventeen years, output per man-hour will be 3 times as great as that today. If working hours and labor force participation rates were to remain unchanged, average family income would approximate $18,000 (in today's prices). Undoubtedly, some part of these potential gains in income will instead be taken in the form of greater leisure—through some combination of shorter hours, later entry into the labor force, and earlier retirement. If the advance of productivity should speed up—as many project—gains in income or leisure could be even greater.

To realize these gains fully, we will need public and private policies that keep the economy operating at its full potential. We must mitigate and, if possible, avoid recessions. We must maintain competitive markets that spur innovation and adapt quickly to change. We must have an increasingly flexible labor force, equipped with the skills needed in a complex, technical economy.

The steps we take during the next few years will help to determine the quality of life in the year 2000.

The patterns of building and transportation that we create will determine the character of our cities. The parks and open spaces that we provide will affect the way people spend their increased leisure time.

With growing population and further urbanization, problems of congestion and pollution—often considered as mere nuisances today—could become obstacles to effective and tolerable city life even before 2000. But imaginative solutions could make the cities of tomorrow not only far more efficient but far more livable than the cities of today.

The vitality of our rural areas in 2000 will also be affected by the success of our efforts to stem their decline and solve their problems in the coming years.

Most important is the need to develop the potential of human beings. The ability of adults fully to participate in—and benefit from—life in 2000 will depend on the investment we make in the children of today.

The educational attainment of the labor force will largely depend on the quality of the education we provide in the next few years. The first grader of 1965 will be the 41-year-old breadwinner of 2000. And the teachers of that year's children are now starting school.

The improvements we make in the medical and public health services available to today's youth will importantly affect death and disability rates of the year 2000 and the physical and mental vigor of the population.

Investments are needed in the health and education of all children. But particular effort is needed for those who have inherited the legacy of poverty and discrimination. We have the means to break the bonds that tie today's children to the poverty of their parents. With proper measures, we could eliminate poverty in the next generation. More individuals would be able to fill the good jobs that advancing technology will offer. With more education, better health, greater incentives, and equality of opportunity, the number of disadvantaged will decline. And the Nation's greatly enlarged resources will permit the diminished numbers of the disadvantaged to share more fully in the prosperity of the society.