policy can be implemented either through tax changes or expenditure changes, decisions regarding Federal expenditures can be properly based on the desired allocation of resources between the public and private sectors.

Third, the record testifies to the effectiveness of a restrictive monetary policy in slowing down the economy, but also to its substantial undesirable side effects in bearing down on homebuilding and straining the financial system. The side effects point to the need for active fiscal policy to avoid placing a disproportionate share of the burden of economic stabilization on monetary policy.

The major shortcomings of economic policy in recent years can be traced to difficulties in achieving prompt and appropriate adjustments in fiscal policy to offset variations in the strength of private demand and substantial changes in defense spending. The next section discusses some improvements that might be made in the formulation and implementation of fiscal policy.

FORMULATING FISCAL POLICY

The focus of fiscal policy in the United States is the annual Federal budget, which is presented in the Budget Message of the President in January. This budget covers the fiscal year starting 6 months later, on July 1. Any analysis of fiscal policy must begin with a consideration of the way in which this budget is formulated in the Executive Branch and the procedures by which the Congress acts on the President's recommendations.

The requirements of economic stabilization are not always fully met, however, by the fiscal program incorporated in the annual budget, no matter how carefully this program is formulated. Conditions may change during the course of the year in such a way as to call for a significant policy response after the annual budget has been planned. Some degree of continuing flexibility is therefore necessary.

One important forward step in budgetary practice was taken when the Federal budget for the fiscal year 1969 was presented. In accord with recommendations contained in the October 1967 Report of the President's Commission on Budget Concepts, a single unified budget was adopted, which covers in a comprehensive way all of the financial activities of the Federal Government. This unified budget provides a much improved statistical basis for formulating fiscal policy and evaluating its economic impact.

THE ROLE OF ECONOMIC FORECASTING

A certain amount of time is required for the economy to respond fully to changes in fiscal—and monetary—policies, and the actions taken at one point in time have effects that are felt over a considerable subsequent period. Whether a policy action will help or impair economic performance depends on the state of the economy in the period following the action. It cannot be judged adequately just by the facts of the economic situation at the time the decision is taken. It must be assessed in light of a forecast.

The responsibility within the Administration for projections of Federal revenues, expenditures, and economic activity rests jointly with the Department of the Treasury, the Bureau of the Budget, and the Council of Economic Advisers. Liaison is maintained with the Federal Reserve Board, which must also forecast economic activity as a basis for its decisions concerning monetary policy.

These projections are particularly important in formulating the annual budget, and they are set forth regularly in the Council's Annual Report. But the evaluation of the economic situation and outlook must be kept up to date during the year. Thus the forecasts are revised for internal use as new information becomes available—indeed, the process of assessing the economic outlook is essentially a continuous one. The projections are frequently supplemented by quantitative estimates of the probable effects of alternative policy actions which might be taken. Quantitative evaluations of the outlook have been prepared for the President essentially on a quarterly schedule ever since 1961. This procedure assures a regular review by the President, with his chief economic and fiscal advisers, of the suitability of the budget program for the needs of the economy.

The techniques used in preparing the Administration's economic projections have changed considerably over the years; but in general they depend on a set of quantitative relationships among economic magnitudes over time. The relationships that are relied upon may be based on formal statistical procedures, subjective expert judgment, or survey data.

To a considerable extent, forecasting relies upon the timely availability of data relating to the economy's past performance which can be used as a basis for projecting its future behavior. Although there are still gaps in economic statistics, considerable progress has been made in recent years by the Department of Commerce, the Department of Labor, and other Federal Government agencies in increasing the quantity and improving the quality of statistical data available for assessing the performance of the economy.

Government agencies also collect valuable information on the anticipated future behavior of some categories of expenditures. For example, the quarterly survey of investment anticipations provides a useful indication of the probable behavior of this highly volatile element of private demand. The Bureau of the Budget prepares up-to-date estimates of future Federal expenditures. Estimates of Federal tax revenues are prepared and kept current by the Treasury Department.

Forecasting was notably successful in gauging in advance the rapid expansion of 1964 and the upsurge from late 1967 into 1968. On some occasions, however, difficulties have been encountered. The strength of the 1965–66 boom was not fully foreseen. Unexpected increases in the personal saving rate intensified the slowdown in economic activity that occurred in the first half of 1967. In the second half of 1968, private demand was stronger than had been anticipated, as noted in Chapter 1. Nevertheless, the whole record makes clear that explicit quantitative projections are superior to extrapolations or hunches, which are the only alternative ways of guiding policy decisions that affect the future.

The need for greater precision in both forecasting and policy formulation has increased greatly in recent years. Between 1961 and 1965, when actual output was consistently below potential, there was little threat of a serious rise in prices, and the risks of excessive expansion were small. Thus emphasis could be placed upon achieving a growth of actual output in excess of that of potential in order to close the gap. Since 1965, however, as actual output has remained relatively close to potential, the need to anticipate and to offset fluctuations in demand has correspondingly increased.

PREPARING THE ANNUAL BUDGET

The Federal budget should be formulated with two objectives in view. One is to provide the amount of fiscal stimulus or restraint needed to keep the economy moving along the potential output path—or to move it back toward that path if a departure has occurred. The other is to choose a level of Federal expenditures that provides the appropriate allocation of national resources between private and public uses. In principle, these two objectives can be pursued independently, since fiscal stimulus or restraint can be provided either by adjusting public expenditures or by adjusting tax rates to influence private spending.

Determining the Extent of Expansionary Action

In developing a budget that is appropriate in terms of fiscal impact, it is necessary at the outset to prepare an economic forecast for a period extending a year and a half beyond the time of budget presentation. The forecast covering the first 6 months of this period—for which the budget outlook has already been fairly well determined—provides the point of departure for viewing economic prospects in the ensuing fiscal year. From that point on, forecasts of private demand are used to determine the appropriate degree of fiscal stimulus or restraint to be provided by the budget.

This determination takes account of the growth of Federal revenues when GNP grows in line with potential in a noninflationary environment at unchanged tax rates. When the economy is in reasonable balance on the path of potential output and private demand is expected neither to weaken nor to accelerate, the forecast will point to the need for expansionary fiscal action sufficient to offset the fiscal drag exerted by normal revenue growth.

If the projection suggests that private demand will weaken or if the economy is operating below potential at the beginning of the year, expansionary fiscal action will be called for in an amount more than sufficient to counteract the restraining effects of normal revenue growth. Conversely, if private demand is expected to strengthen or if the economy is operating above potential at the beginning of the year, an amount of expansionary fiscal action less than sufficient to offset the restraining effects of normal revenue growth will be required—or, in an extreme case, some additional restraint, beyond that provided by normal revenue growth, may be necessary.

The desired amount of expansionary (or restrictive) fiscal action, as indicated by the forecast, can be provided either by increasing (reducing) Government expenditures, by reducing (increasing) tax rates, or by some combination of the two. A decision therefore has to be made whether to adjust taxes, or expenditures, or both. This decision involves difficult choices about the allocation of resources between public sector programs and the private sector.

Public Expenditures and Tax Changes

In order to make these choices intelligently, it is necessary to examine carefully the proposed Federal expenditures having the highest priorities—whether they be for the expansion of existing programs or for new initiatives—and judge whether the public needs that would be met by these programs are more or less urgent than the demands of the private sector that would be satisfied by tax reduction.

Allowance ordinarily has to be made for a virtually unavoidable increase in expenditures sufficient to keep pace with rising costs and rising workloads under existing Federal programs. The decision would, however, still have to be made whether any needed restraint or additional stimulus over and above that provided by this built-in expenditure growth should come from changes in tax rates or in expenditures.

All of this suggests that there is no reason to suppose that the proper allocation of resources between public sector and private sector activities would be achieved by keeping tax rates constant and adjusting Federal expenditures to meet the requirements of fiscal policy. It should be perfectly normal for the President to recommend a change in tax rates in his annual Budget Message. Such proposed changes have in fact been a feature of the last seven annual budgets. Indeed, consideration of the appropriateness of tax rates should be a normal part of the budget program—if no change is being proposed, the President should explain why existing tax rates are regarded as appropriate. If Government expenditures move ahead year by year at a rate about equal to the growth of tax revenues, changes in tax rates may not need to be made very often. However, it would be a remarkable coincidence if a steady growth in Government expenditures at that rate simultaneously satisfied the needs of economic stabilization and the Nation's wishes over the long run with respect to the proper allocation of resources between the public and private sectors of the economy.

Sharp increases in defense spending pose special issues relating to the allocation of resources between Federal nondefense programs and the private sector. A sharp increase in defense expenditures normally requires a compensating fiscal adjustment to prevent the budget from becoming undesirably stimulative. In principle, any needed adjustment can be accomplished either by increases in tax rates or reductions in Federal nondefense outlays. For a number of reasons, however, increases in tax rates should normally be the main instrument. First, sharp slashes in Federal nondefense programs are simply not administratively feasible in the short run. Second, social priorities for the nonmilitary public sector would be violated if these programs carried the major burden of fiscal adjustment. The overhead cost on society of increased defense requirements should be expected to be borne primarily by the 80 percent of GNP that represents private uses of output. It seems evident that the roughly 10 percent of GNP which Federal nondefense spending represents should not be expected to carry the major part of the load. This seems particularly compelling in a Nation which is affluent in general and yet beset by serious social problems. While it is entirely appropriate for some types of nondefense spending to be cut and stretched out in order to ease the fiscal problem, there are strong grounds for avoiding reductions in social programs that deal with the urgent problems of poverty and urban blight.

CONGRESSIONAL PROCEDURES

If fiscal policy, as embodied in the annual budget, is to make its maximum contribution to economic stabilization, some changes in Congressional procedures for reviewing and determining the budget would be desirable.

General Budget Review

One important problem lies in existing Congressional procedures for determining budget authority and hence Federal expenditures. In both the House and Senate, budget authority is essentially controlled by 13 separate appropriations subcommittees which determine budget authority for individual agencies and programs. Their individual decisions can lead to a total of budget authority and outlays that is not controlled nor determnied in a coordinated way. The Legislative Reorganization Act of 1946 called for a concurrent resolution on an expenditure total in advance of appropriations, but this limitation was not integrated into the appropriations procedures.

Congress needs new machinery which ensures that the actions taken on authorizations and outlays for particular programs will add up to a total that achieves an appropriate allocation of resources between Federal programs and the private sector of the economy. This machinery should focus specific attention on the level of taxes required in conjunction with any given total of outlays in order to achieve an appropriate fiscal policy. In making its judgments on these matters, the Congress would presumably begin with the Administration's expenditure and tax recommendations as contained in the January Budget. Then, assuming no major disagreement with, or change in, the basic economic outlook, any proposals to change the expenditure total substantially from that recommended in the Budget should be accompanied by a corresponding proposal for adjusting taxes. If such machinery could be satisfactorily introduced, it would help produce a more coordinated Congressional decision on both expenditures and taxes.

Procedures for Tax Changes

Procedures for a general review of the economy's fiscal needs along lines suggested above should expedite whatever specific action on taxes might be needed for fiscal policy purposes. In most circumstances, normal Congressional procedures for enacting the needed tax legislation would probably be satisfactory—especially if the Congress were to agree in advance on a form of tax adjustment that would be judged appropriate for this purpose. A proportional change in individual and corporate income taxes—like the current surcharge—might be a suitable form of adjustment.

However, the experience of the 1960's, including the costly delays in the passage of the 1964 tax cut and the 1968 tax surcharge, suggests the desirability of some other standby arrangement for obtaining prompt adjustments in tax rates to achieve fiscal policy objectives in case of a delay in reaching a decision through normal Congressional procedures. As noted in Chapter 1, the Administration has requested that the Congress consider giving the President discretionary authority, subject to Congressional veto, to remove the current surcharge entirely or partially if warranted by developments. A more permanent arrangement to provide the desirable flexibility could take various forms, including:

1. Presidential discretion to propose temporary changes in personal income tax rates within certain specified limits—such as 5 percent in either direction—subject to veto by the Congress within (say) 30 days. This year's Budget Message contains such a proposal.
2. A streamlined Congressional procedure for ensuring a prompt vote on Presidential proposals for changes in tax rates within certain specified limits. This would not shift any of the traditional powers of Congress to the President; the Congress would simply change its own rules.

Since changes in tax rates required for fiscal policy objectives would probably take the form of simple modifications of the basic schedule of rates, it would be necessary also to ensure opportunities for a thoroughgoing review of the over-all structure of the revenue system, including the tax base and rates. A structural review of rates would be especially appropriate if rates should drift downward (or upward) consistently for a period of several years as a result of fiscal adjustments. It is important, however, that the issues of tax reform be treated and considered separately from the annual tax decisions related to fiscal policy.

ADJUSTING TO NEW DEVELOPMENTS

Under the procedures outlined above, it would surely take several months for full legislative response to the President's January Budget. During that period, both the Congress and the Administration would be alert to any major unanticipated developments in the strength of private demand, in Federal defense needs, and in the desired mix of fiscal and monetary policy. Any such developments could and should be reflected in the implementation of the budget program.

If the annual budget is carefully formulated and implemented, the need for a significant subsequent revision of the budget program later in the year should be the exception rather than the rule. Stabilization requirements could largely be met by reliance on automatic stabilizers and monetary policy.

Much of the success of these stabilization efforts would depend upon the Federal Reserve's flexibility in adjusting monetary policy to circumstances as they unfold. In the development of the annual budget, there should be close consultation and coordination with the monetary authorities. A tentative projection of monetary and credit conditions should be prepared as part of the forecast underlying annual budget decisions. The fiscal program should minimize the risk of putting an excessive share of the burden of economic stabilization on monetary policy, as happened in 1966. But monetary policy should not be bound by the projections made at budget time—if conditions change, it should be adjusted accordingly. Indeed, given a reasonably appropriate fiscal policy, the further adjustments needed to keep the economy reasonably close to potential output should normally be within the capability of the Federal Reserve.

It should be recognized, however, that major unforeseen developments may significantly modify the path of demand anticipated in the annual budget. As mentioned earlier, private demand has on occasion exhibited substantial unexpected strength or weakness.

A major problem in recent years has stemmed from the uncertain path of increases in defense spending during the Vietnam buildup. While it is to be hoped that such a military buildup will not again be necessary, there can be no assurance in an insecure world that this will be the case. Accordingly, it is essential to be prepared to deal with such contingencies. Moreover, there could be similar and equally challenging problems of gauging the magnitude and timing of a demobilization—when peace is established. A special report to the President discussing the challenges and opportunities that will confront policymakers when peace comes in Vietnam is included in this volume.

The path of defense orders and outlays is inherently difficult to predict in a period of military flux. Through intensified efforts of the Department of Defense, considerable progress has nevertheless been made in providing an improved flow of information relating to both the current and prospective economic impact of defense spending. Some of this information is now being made public by the Bureau of the Census in a monthly digest entitled

Defense Indicators. Further efforts are needed, together with a full awareness of the importance of accurate information, especially at critical turning points in the trend of defense spending.

SOME ISSUES OF MONETARY POLICY

The record of the past 8 years demonstrates that flexible, discretionary monetary policy can make an effective contribution to economic stabilization. The economy's gradual return to full productive potential in the early 1960's was partly attributable to a monetary policy which kept ample supplies of credit readily available at generally stable interest rates. And in early 1967, the prompt recovery of homebuilding after the 1966 slowdown was the direct result of timely and aggressive easing of credit conditions by the Federal Reserve.

The most dramatic demonstration of the effectiveness of monetary policy came in 1966, however, when a dangerously inflationary situation was curbed primarily by a drastic application of monetary restraint. Credit-financed expenditures at the end of that year appear to have been as much as $8 billion below what they might have been had monetary policy maintained the accommodative posture of the preceding 5 years. And there were substantial further "multiplier" effects on GNP as these initial impacts reduced income and consumption spending.

THE CONDUCT OF MONETARY POLICY

The primary guides for monetary policy are the various broad measures of economic performance, including the growth rate of total output, the relation of actual to potential ouput, employment and unemployment, the behavior of prices, and the Nation's balance-of-payments position. Extensive research, together with the experience of the last few years, has increased our knowledge of the complex process by which monetary policy influences these measures. While there are still major gaps in our knowledge of the precise chain of causation, some conclusions seem well established.

Like fiscal policy, monetary policy affects economic activity only after some lag. Thus actions by the Federal Reserve must be forward-looking. In considering the prospects ahead, however, an assessment must be made of both the expected behavior of the private sector and of the likely future course of fiscal policy. As noted earlier, the inherent flexibility in the administration of monetary policy permits frequent policy adjustments to take account of unexpected developments in either the private or the public sector.

Sectoral Impacts

Monetary policy can affect spending through a number of channels. To some extent it works by changing the terms of lending, including interest rates, maturities of loans, downpayments, and the like, in such a way as to encourage or discourage expenditures on goods financed by credit. There