

The Nation's potential output has grown by an estimated 28 percent since early 1961. The rate of increase is currently about 4 percent a year, reflecting a 1½-percent rise in available man-hours and a 2½-percent rate of increase in output per man-hour.

Available man-hours grow slightly less rapidly than the labor force. The recent normal growth trend of the labor force is about 1¾ percent a year. This is rapid by previous standards and reflects the high birth rates of the immediate postwar years. Under steady employment conditions, however, longer vacations, shorter workweeks, and an increasing employment of part-time workers—mostly women—lead to a decline of about ¼ percent in average hours worked per year. This holds the trend of growth in total man-hours to about 1½ percent a year.

As a result of a more skilled and better trained labor force, improved management and technology, and the enlarged quantity and higher quality of the capital stock, the Nation experiences growing productivity—as measured by output per man-hour. In the postwar era, the trend in the growth of productivity in the private economy has been somewhat over 3 percent a year. However, improvements in the efficiency of Government workers are not statistically measured, and are arbitrarily taken at zero. Therefore, the trend rate of increase in output per man-hour for the total economy—private and public—is just over 2½ percent a year. The growth rate of potential output is therefore about 4 percent a year currently. It exceeds the 3½-percent rate estimated for the late 1950's and early 1960's primarily because the growth of the labor force has accelerated.

The vigorous advance of aggregate demand in recent years has assured that the economy's great and growing productive potential has been generally realized in actual output and not squandered in idleness.

### FISCAL POLICY IN THE 1960'S

The improved and fuller use of our productive capabilities in the 1960's has been significantly influenced by fiscal and monetary policy. It is no accident that this most successful period of sustained growth in our economic history has coincided with a new and determined commitment to apply economic policies in active pursuit of the goals of the Employment Act.

The balanced expansion of 1961–65 was strongly supported by stimulative fiscal measures. Federal tax liabilities were lowered through depreciation reform, the investment tax credit, a sharp reduction in personal and corporate tax rates, and the reduction or elimination of many Federal excise taxes. Increases in expenditures during the period provided for the introduction and expansion of high priority social programs and, in 1961–62, for stepped-up defense needs.

As discussed in detail below, monetary policy played a vital role during this period in insuring that the growing credit needs of the expanding economy were adequately met.

The rapid expansion of spending for the Vietnam conflict threw the economy off stride after mid-1965. But the economic strains inherent in the defense buildup were moderated by adjustments in policy. In particular, monetary policy played a much more active role in 1966 and 1967 than in the preceding period.

A review of fiscal policy prior to the 1960's is helpful in understanding the more recent developments.

#### THE HERITAGE OF CURRENT FISCAL POLICY

The conscious use of Federal tax and expenditure policy to help promote high employment and healthy growth dates back at least to the 1930's. Since World War II, fiscal policy has contributed to the improved record of economic stability both through the greater importance of automatic stabilizers and the growing use of discretionary policies.

##### *Automatic Stabilizers*

Several features of the postwar budgetary system have helped to increase economic stability passively and automatically. Because the Federal tax system relies heavily on personal and corporate income taxes, tax liabilities increase or decrease along with economic activity. A decline in activity reduces incomes, which, in turn, automatically results in reduced tax receipts even if tax rates are not changed. The fall in after-tax spendable incomes of individuals and corporations is thus cushioned by the amount of the decline in tax revenues. As a result, secondary reductions in spending are smaller than they would otherwise have been, and the ultimate decline in output and incomes is more limited. The same kind of stabilizing effect occurs, to a degree, in Federal expenditures, because certain outlays—especially unemployment benefits and welfare payments—automatically increase in a period of contracting economic activity and thus support consumer spending.

When economic activity rises, these same stabilizers work in the opposite direction. Every rise in income leads to higher tax collections which—given the level of Federal expenditures—restrict further increases in private spending. To the extent that the rise in private incomes reduces Federal outlays for unemployment benefits and welfare payments, the dampening effect is further strengthened.

Automatic fiscal stabilizers are more important now than they were before World War II. Over much of the postwar period, they have been the primary reliance of stabilization policy. To a large extent, the increased strength of the stabilizers simply reflects the higher tax rates in the postwar period, accompanying the greater importance of defense spending and the enlarged civilian responsibilities of the Federal Government. The automatic stabilizers were also made more powerful as a result of structural changes, such as the introduction of unemployment insurance and the greater reliance on progressive income taxes—receipts from which

fluctuate proportionately more in response to income changes than those from other taxes.

The frequency of recessions from 1948 to 1961 was not notably reduced from earlier times, which is not surprising. Automatic stabilizers cannot prevent a decline; they merely help to limit one once it starts. But the automatic stabilizers have helped to make postwar recessions brief and relatively mild. The workings of the automatic stabilizers created substantial Federal deficits in each postwar recession, which were accepted by each Administration as a beneficial stabilizing influence.

### *Discretionary Policies*

Discretionary fiscal actions were also used at times to stimulate the economy during recession periods and early stages of recovery. Certain tax rates were allowed to fall as scheduled at the start of 1954, in full recognition that this would further unbalance the Federal budget. Increases in Federal expenditures helped to insure and accelerate recovery in 1958. Although these actions were taken considerably after the onset of recession, they played a constructive role in strengthening recovery.

In one major instance, discretionary fiscal actions also were taken to curb inflationary pressures of excess demand. Three separate legislative actions to raise corporate and individual tax rates in 1950–51 helped to restrain a booming Korean defense economy. Civilian budgetary expenditures were also substantially trimmed. Although most support for these actions reflected the traditional view that more money was needed simply to “pay for the war,” there were many—both within and outside the Government—who understood fully the role of fiscal policy in stabilizing the economy.

The discretionary actions that were taken during the decade of the 1950's seem, in retrospect, to have worked in the right direction. The cases in which fiscal policy seems to have gone astray involve errors of omission rather than commission.

A particularly instructive case was the reliance on automatic stabilizers during the upswing from 1958 to 1960. When the economy is in an inflationary surge, restraint from the automatic stabilizers is a welcome force. Under some circumstances, however, the expansion of tax revenues that accompanies economic growth can exert an undesirable restraint. As the 1958–60 period illustrated, it can become a “fiscal drag” preventing the attainment or maintenance of high employment. Unless there is some combination of higher Federal expenditures and reduction in tax rates equivalent to the normal growth of revenues, the Federal budget becomes increasingly restrictive over time.

The possibility of reductions in tax rates was widely advocated and seriously discussed early in 1958, but no action was taken. Although expenditures rose sharply during the course of that year, they leveled off thereafter and showed no upward trend from the end of 1958 to mid-1960. Because Federal

expenditures stood still and tax rates were unchanged, the budget began to exert a significant fiscal drag. For a time, private demand strengthened enough to keep the economy advancing. But as private demand lost its vigor, the economy turned down in the spring of 1960, and the fourth postwar recession began.

#### BUDGETARY ACTIONS, 1961–65

When the Kennedy Administration took office, the 1960–61 recession had essentially run its course, cushioned by the automatic stabilizers and by a prompt shift to a strongly expansive monetary policy. But the Nation's output was far below its potential and the unemployment rate stood at 6.8 percent, close to a postwar record high.

The Federal sector was in deficit by \$½ billion (annual rate) in the fourth quarter of 1960 on the national income account basis (which is the measure employed throughout this Report). At the same time, however, tax receipts were being held down by the major shortfall of incomes below the economy's potential. If, in fact, the economy had been operating at its potential, there would have been a Federal surplus of an estimated \$13 billion. This hypothetical measure of the "full-employment surplus" is abstract and imprecise, but it is a useful way of distinguishing between the passive operation of automatic stabilizers and discretionary shifts in the budget. If private demand weakens and the economy contracts, thereby lowering tax revenues, the actual Federal surplus will be substantially reduced (or deficit increased), even with no discretionary changes in expenditures or tax rates. But the full-employment surplus would not thereby be altered; it would continue to reflect what expenditures and tax yields would be at potential output levels. On the other hand, higher discretionary expenditures or a reduction in tax rates would be reflected in a lower full-employment surplus, as well as in an initial decline of the actual surplus.

The huge gap between actual and potential output early in 1961 was a clear signal that expansionary fiscal actions were needed. If the restraining impact of the large full-employment surplus continued, the economy's potential could be realized only through a compensating excess of private investment over private saving at potential output in an amount larger than 2 percent of GNP. That would have required extraordinary buoyancy of private demand, which did not appear to be present or forthcoming.

#### *Expansionary Actions in 1961–62*

Significant fiscal steps were taken in 1961 to stimulate the economy. A liberalization of social security benefits was accelerated and increases in public assistance were initiated. Advances in defense spending were required by growing international tensions, and these accomplished a part of the stimulative job which might otherwise have been carried out by tax cuts or strengthened civilian programs. The full-employment surplus was brought down to \$9 billion by the end of 1961. Meanwhile, the economy's early re-

covery from recession was strong and brisk, narrowing the gap between actual and potential output by some \$15 billion (1958 prices) from the first to the fourth quarter.

It was expected that this initial stimulus would touch off a strong and sustained rise in business spending. But after five years of experience with sluggish markets and excess capacity, businessmen were not prepared to raise plant and equipment spending far in advance of the growth of demand. The economy continued to advance but at a much slower pace; progress toward full employment was interrupted early in 1962. The gap between actual and potential output remained between \$25 and \$30 billion (1958 prices) and the unemployment rate hovered around 5½ percent.

Two key tax measures were adopted in 1962 to stimulate investment: depreciation rules were liberalized and an investment tax credit of 7 percent on machinery and equipment was enacted. These measures were designed for the long run and were not expected to yield large results immediately. The tax actions were combined with moderate further increases in Federal expenditures. Even so, the revenue growth of a normally expanding economy swung both the full-employment surplus and the actual deficit toward restraint in the second half of 1962.

#### *Tax Reduction in 1964 and 1965*

Against this background, President Kennedy announced in August of 1962 his intention to propose a major stimulative tax reduction, along with important tax reforms. The proposal was subsequently spelled out in the January 1963 Budget program. This was an unprecedented step; it initiated a major expansionary fiscal action at a time when the economy was neither in recession nor threatened by imminent recession, the Federal sector was in deficit, and Federal expenditures were continuing on an upward trend. The tax program was based on the diagnosis and forecast that a substantial further reduction in the Federal full-employment surplus was needed, given the state of private demand, to produce a sustained and balanced expansion of output up to the potential level.

The tax proposal was intensively debated in Congress, but action on it was not completed in 1963. Meanwhile, expenditures grew less rapidly than either the actual or potential advance of revenues and the budget became even more restrictive. The march toward full employment was resumed with the enactment in February of the Revenue Act of 1964—President Johnson's first major legislative achievement. Individuals received an average cut of one-fifth in their tax liabilities in two stages covering 1964 and 1965. The reduction for corporations was about one-tenth; combined with the earlier tax measures of 1962, corporate taxes were brought one-fifth below the level of 1961. When the cut in tax liabilities had become fully effective in 1965, it totaled \$15 billion. (By 1967 the annual saving to taxpayers due to the tax reductions in the 1964 act had grown to more than \$18 billion.)

The effects of the tax reduction on private demand were clear and dramatic. An upsurge in consumer spending indicated that most of the extra take-home pay resulting from tax reduction was being spent in the Nation's shops and markets. Responding to the vigor of consumer demand, business investment spending forged ahead. In late 1964 and early 1965 the unemployment rate dropped below 5 percent for an extended period for the first time in seven years. The estimated gap between actual and potential output was narrowed to \$11 billion (1958 prices) in the first half of 1965. The gains in income produced a huge rebound in Federal receipts, bringing the Federal sector into surplus in the first half of 1965.

New stimulative policies were prepared in the spring of 1965 in order to complete the advance to full employment. In line with the President's proposals, Congress enacted a major, phased reduction of excise taxes. The first stage took effect in June 1965, cutting taxes by \$1¼ billion (annual rate). A retroactive liberalization of social security benefits was enacted.

### Summary

The over-all operation of fiscal policy from the end of 1960 to the middle of 1965 is summarized in Table 6. Expansionary fiscal actions over the period totaled \$38 billion—\$25½ billion through expenditure increases and \$12½ billion through net tax reductions. A gross total of \$15½ billion of tax cuts was offset in part by social security tax increases of \$3 billion.

If tax rates had remained unchanged, normal revenue growth (calculated at full employment) over the 4½-year period would have amounted to

TABLE 6.—*Federal fiscal actions in two periods since fourth quarter 1960*

[Billions of dollars, seasonally adjusted annual rates]

Item	1960 IV to 1965 II	1965 II to 1967 IV <sup>1</sup>
Federal expenditure increases <sup>2</sup> .....	25.5	48.0
Defense purchases.....	3.5	25.0
Other purchases.....	7.5	1.5
OASDHI <sup>3</sup> benefits.....	5.0	10.0
All other <sup>4</sup> .....	9.5	11.5
Federal tax reductions <sup>5</sup> .....	12.5	-6.0
Corporate.....	5.5	-----
Personal.....	8.5	-----
OASDHI <sup>3</sup> payroll taxes.....	-3.0	-8.5
Indirect business.....	1.5	2.5
Total expansionary actions <sup>6</sup> .....	38.0	42.0
Normal revenue growth at full employment.....	30.5	27.0
Change in full employment surplus <sup>7</sup> .....	-7.5	-15.0

<sup>1</sup> Preliminary.

<sup>2</sup> Includes adjustment in unemployment insurance benefits for change in unemployment rate.

<sup>3</sup> Old-age, survivors, disability, and hospital and related insurance (OASDHI).

<sup>4</sup> Consists of transfers other than OASDHI, grants, interest, and subsidies.

<sup>5</sup> Minus sign indicates an increase in tax.

<sup>6</sup> Sum of expenditure increases and tax reductions.

<sup>7</sup> Normal revenue growth minus expansionary actions.

Sources: Department of Commerce and Council of Economic Advisers.

\$30½ billion. Because expansionary actions exceeded this “fiscal dividend,” the full-employment surplus was reduced by \$7½ billion. In contrast, the actual balance shifted from a fractional deficit to a surplus of nearly \$5 billion, reflecting the vigorous advance of private demand.

The precise movements of the budget during the 1961–65 period were not perfect in size or timing. But they clearly did the job of promoting orderly progress toward full employment without straining over-all productive capacity or creating serious bottlenecks.

#### CHALLENGES OF PROSPERITY

As of mid-1965, there was every reason to believe that the record of orderly progress could be extended. The expansion was characterized by remarkable balance in all sectors and strong forward momentum. The fiscal program and monetary policy that ruled at the time seemed appropriate to the economy’s needs. The main future task of budgetary policy appeared to be that of distributing the fiscal dividend—providing for expenditure increases and tax reductions that, in combination, approximately matched the economy’s normal revenue growth along a rising trend of full-employment GNP.

Nevertheless, the fuller use of resources posed new problems of diagnosis and policy application. Previously, the risks had been almost entirely on the side of insufficient demand; and the primary task of policy had been to provide stimulus. As the unemployment rate fell toward 4 percent, the economy entered territory that had been uninhabited for nearly a decade. There were now risks on both sides—not only of inadequate but of excessive stimulus.

No one could know precisely how fully resources might be used without unleashing inflationary forces. In 1961, the Council had set an interim target of a 4-percent unemployment rate, intending to review the possibility of adopting a more ambitious goal in light of the actual operation of the economy in the neighborhood of 4-percent unemployment.

In the period of slack, excess supply and unused productive capabilities created buyers’ markets. In such circumstances, the human costs of inadequate demand are very large while the risks of price inflation are likely to be small. As full utilization is attained, the pressures toward higher prices increase, as Chapter 3 indicates. And, if excess demand becomes widespread and sellers’ markets generally come to prevail, a wage-price spiral and accelerating inflation can result. Finding acceptable and feasible ways to reconcile high employment with reasonable price stability thus becomes a major challenge to policy in a prosperous economy.

In 1965, the Nation stood ready to face this welcome challenge. However, the task of stabilization was immensely complicated by the sharp increase in defense spending after mid-1965.

*Defense and the Budget, 1965-67*

A marked rise in defense spending inevitably creates problems for fiscal management, especially when the economy is close to full employment. The additional defense requirements since mid-1965 have absorbed about one-fourth of the Nation's growth in real output. Thus, the production available for private use has continued to rise. Yet the advance in defense spending has been sufficiently large to dominate the Federal Budget in this period. It accounts for the fact that we now face the need for tax increases rather than further opportunities for a welcome tax reduction.

From the middle of 1965 to the end of 1967, the increase in Federal expenditures was \$48 billion, as shown in Table 6. Some \$25 billion of this was for defense. Of the \$10 billion increase in OASDHI benefits, about \$6 billion represented the landmark social decision to provide improved health care for the aged under social security, and the balance represented normal growth in the ongoing programs. The \$10 billion increase in OASDHI benefits was more than covered by increased payroll taxes. Other nondefense expenditures increased by \$13 billion. Over the same period, normal growth of Federal revenues at full employment—at constant tax rates—amounted to about \$27 billion. In addition, there were net tax rate increases which added about \$6 billion to revenues.

All in all, with the large rise in defense outlays and the high priorities for certain public civilian programs, the \$48 billion increase in expenditures far outpaced the normal expansion of revenues plus the effect of tax rate increases. As a result, the Federal budget became very expansionary over these 2½ years, with a drop of \$15 billion in the full-employment surplus.

It should be noted that the advance of \$13 billion in nondefense expenditures other than for social insurance was only about half the normal growth of revenues other than from payroll taxes.

*Fiscal Policy, 1966-67*

A variety of policy measures—both fiscal and monetary—was adopted over the 2½-year period to cope with the pressures resulting from the increase in the defense budget. The design of policy actions was made especially difficult by uncertainties about the future path of defense outlays.

After the exceedingly rapid economic advance during the second half of 1965, the need for restraint in policy was clearly recognized at the beginning of 1966. An already scheduled rise in payroll taxes for social insurance amounting to \$6 billion (annual rate) took effect at the start of the year. The President's budgetary program reinforced this restraining influence with requests for a new graduated withholding system on individual income taxes, for a reversal of certain scheduled excise tax reductions, and a speedup in the collection of corporate income taxes. As enacted by the Congress in

March, these measures siphoned \$2½ billion (annual rate) from the private economy. Nevertheless, a large part of the burden of providing restraint fell on monetary policy.

The effects of tight money were evident in a sharp contraction of homebuilding during the course of 1966, which in turn contributed to a moderation of the over-all economic advance. But business investment spending proved unresponsive to monetary tightness—at least in the short run—and continued to advance at a rapid rate during the spring and summer of 1966. The investment boom put severe strain on the plant capacity and labor supplies of the machinery and construction industries. There was also danger that an excessive and unsustainable surge of plant and equipment spending might set the stage for a subsequent slump in investment demand. Finally, the investment boom added mightily to the pressures on financial markets during the spring and summer of 1966.

The dramatic decline in homebuilding, the highly disturbed atmosphere of financial markets, and the pressures of business fixed investment on capital goods industries clearly indicated that fiscal policy needed to assume a larger share of the responsibility for restraining the economy.

In the light of these considerations, the Administration in September 1966 requested a temporary suspension of the investment tax credit, initiated certain cutbacks in Federal spending, and placed stringent limits on net new issues by Federal agencies. At the same time, the monetary authorities took various complementary steps to ease the pressure on financial markets, including, in particular, a direct request to member banks to restrict their business lending. In addition, legislative and other action was taken to moderate the competition for savings—and improve the flow of credit—through the adoption of new rules governing interest-rate ceilings on time and savings accounts at banks and thrift institutions.

The suspension of the tax credit was enacted by the Congress in October. The capital goods boom halted, and business spending on plant and equipment declined slightly during the first half of 1967. The suspension of the investment credit contributed to this result, but monetary policy and the other activities cited, as well as the general slowdown of the economy, were also partially responsible. It can be argued, in retrospect, that investment demand might have slowed down adequately without suspension of the tax credit. But the impact of the September fiscal program on financial markets was clear and beneficial beyond any reasonable doubt.

Long-term interest rates responded quickly to the President's fiscal proposals and declined from the sharp peaks reached during the first week of September 1966. Subsequently, the Federal Reserve System relaxed its monetary restraints. As a result of this shift in the mix of stabilization policies, the recovery of homebuilding got a head start of several months. After the suspension of the investment credit had done its job, the credit was restored by Congress in the spring of 1967 upon recommendation by the President.

As described in Chapter 1, fiscal policy exerted a major expansionary influence in the first half of 1967 when the economy was particularly sluggish. The large and growing full-employment deficit, reinforced by an expansionary monetary policy, helped maintain the forward motion of the economy. When economic activity strengthened in the second half of the year, the President called for prompt tax action to moderate the stimulus of fiscal policy, and initiated a program to curb Federal expenditures. As Congress adjourned without acting on the proposed tax surcharge, the year ended with renewed financial strains and with the recovery in homebuilding once again threatened by credit stringency.

### MONETARY DEVELOPMENTS

Through nearly five years of economic expansion, monetary policy reinforced expansionary fiscal measures. In 1966, however, monetary policy became a major restraining force. When inflationary pressures diminished late in 1966, a relaxation of credit policies was initiated and subsequently maintained through most of 1967.

#### BALANCED EXPANSION, 1961-65

From 1961 until late in 1965, monetary policy was consistently expansionary; it made a major contribution to the advance of the economy by accommodating growing credit demands at remarkably stable interest rates.

To be sure, short-term interest rates rose during this period, as monetary policy and debt management actions deliberately sought to keep key short-term rates in the United States reasonably aligned with those in foreign money centers so as to limit outflows of interest-sensitive funds. Long-term rates, however, were only slightly higher in mid-1965 than in early 1961 (Chart 5). Indeed, some important interest rates—those on mortgages and State and local government bonds—were lower than they had been at the beginning of the period of expansion.

A policy of monetary ease was indispensable to provide the 60-percent increase in funds raised by businesses, governments, and individuals without any substantial tightening of availability or increase in long-term rates. Meanwhile, demands for funds burgeoned mainly because of the invigoration of demands for goods and services that stemmed from an actively expansionary fiscal policy.

#### *Institutional Changes*

During this period, there were significant changes in the character of financial instruments and in the behavior and practices of financial institutions.

In particular, the long-term tendency for businesses to economize in the holding of demand deposits was reinforced by the development of new money market instruments, notably the negotiable time certificate of deposit (CD). Upward revisions in the maximum interest rates which Federal regulations allowed to be paid on time and savings deposits enabled commercial banks to attract large inflows of such deposits.