Kennedy's Supply-Side Economics

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The goal was full employment, economic growth, and price stability. The means included supply-side measures like investment tax credits, liberalized depreciation rules, wage-price guideposts, and an initial restraint on tax cuts.

The economics of the Kennedy years and of the 1964 tax cuts have become a born-again issue in the current debate over President Reagan's economic program. As seen through the inverted prism of the supply-side revisionists, successful Kennedy tax cuts "prove" the case for broad-scale personal tax reduction as the key to a great leap forward in the economy's capacity to produce—in other words, as the key to self-financing and anti-inflationary tax cuts. As objectively as I can, and at the risk of repeating things I have been saying for nearly twenty years, let me review the rationale and record of Kennedy economics.

What was so new about the "New Economics," as the press quickly dubbed the Economics of the New Frontier in 1961? Not the theory—much of that went back nearly a quarter of a century to John Maynard Keynes. What *was* new, however, was the translation of modern economics into practice under the leadership of a willing and responsive President (who, at the very outset, directed his Council of Economic Advisers to "return not just to the letter but to the spirit of the Employment Act of 1946").

The main elements

The main elements of the new stamp that the Kennedy administration put on policy and policy-making were the following:

The translation of the fuzzy mandate of the Employment Act of 1946 to achieve "maximum employment, production, and purchasing power" into the concrete goals of full employment, price stability, more rapid growth, and external pay-

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ments equilibrium (under the constraints of maintaining freedom of economic choice and promoting greater equality of economic opportunity).

• Even more important was the Council's conversion of the key qualitative goals into specific quantitative targets, and the President's endorsement of those targets. Thus, in place of a general but vague commitment to "full employment," the Kennedy administration adopted a specific target of 4 percent unemployment (at a time, by the way, when the 1960 recession had boosted unemployment to 7 percent). The target for economic growth—that is, the growth in the economy's potential to produce—was set at 4 percent per year in place of the 3 percent to 3.5 percent rate of growth in potential GNP in the Eisenhower years (and the 2.5 percent actual rate of expansion of real GNP in those years). As to price stability, the goal was to maintain the very low rate of inflation (just over 1 percent per year) left as a welcome legacy of the Eisenhower era at the heavy cost of three recessions in eight years, high unemployment, and low rates of growth. Once these numerical targets were adopted, they exerted a discipline on policy that the more abstract and qualitative goals could not achieve.

• Equally significant was the concomitant shift in policy focus from moderating the swings of the business cycle to achieving the full-employment potential of the economy. It was not enough simply to reverse recessions and temper expansions. Success was to be measured in terms of hitting a moving target, namely, the economy's rising full-employment potential. The point was to close the gap between actual and potential output, without triggering inflation.

• The concepts of full-employment potential and gap-closing were not brand new—they trace back to the bold and innovative Truman Council under the leadership of Leon Keyserling. But until Kennedy came along, the country never had a President who was willing to embrace such seemingly unorthodox doctrines and unabashedly move modern economics to the front burner.

• Also new and different was a positive policy of voluntary wage-price restraint. The Kennedy wage-price guideposts were introduced in January 1962 to induce labor and business to hold wage and price increases within the bounds of productivity advances and thus help ensure that fiscal-monetary stimulus would not run off into higher prices and wages but would instead express itself in higher output, jobs, profits, and investment. Indeed, the 1961-65 record shows that the guideposts played their part: wage increases in manufacturing stayed within the bounds of productivity increases, thus contributing to continued price stability and a sustained advance in real wages and living standards. Corporate profits doubled in those years.

• Less tangible, but no less important, was the orchestration of policy through skilled White House management, utilizing such instruments as the Troika (Treasury, Budget, and the Council of Economic Advisers [CEA]), and the Quadriad (adding in the Federal Reserve Chairman). Economic policy differences were ironed out and presented to Congress and the public as a united and coherent effort.

• The vital ingredient in this was the leadership by a sagacious President, quick to accept sound new thinking and to reject the old clichés that had hobbled policy. Banished were the beliefs that deficits in a weak economy were instruments of the devil and that public debt was a "burden on our grandchildren." John F. Kennedy was the first President to free us of these shibboleths, to relate budget-balance not to the calendar year but to full employment as a target, and thus to facilitate a more activist economic policy.

• Side by side with the new activism was the President's use of the White House "as a pulpit for public education in economics" (a use he urged on us even before his inauguration). Just as he advised his staff to explain and clarify the goals, concepts, and policies of the "New Economics" to the press, on television, and so on, the President himself provided a sense of direction through his own speeches to business and financial groups, national TV programs, press conferences, and the famous Yale commencement speech in June of 1962.

• Finally, one should mention the quality of economic thinking that President Kennedy attracted throughout his administration, not just in the CEA but in such outstanding economic and financial leaders as David Bell in the Budget Bureau, Douglas Dillon and Robert Roosa in the Treasury, and George Ball in the State Department. The CEA had as Council members Kermit Gordon, James Tobin, Gardner Ackley, and John Lewis; as staff members, Kenneth Arrow, Robert Solow, Arthur Okun, George Perry, William Capron, Lloyd Ulman, Nancy

Teeters, Vernon Ruttan, Warren Smith, and Richard Cooper; and as close-in consultants, the likes of Paul Samuelson, Charles Schultze, Joseph Pechman, Otto Eckstein, and John Meyer.

The first year: supply-side economics

Except for a quick but mild dose of demand stimulus in an early 1961 anti-recession package, the first year was essentially a year of supply- and cost-side measures. We did not use the catch phrase, "supply-side economics," but that's exactly what it was:

First, introduction of the investment credit, to this day the back-bone of tax incentives for growth through business capital formation. It was proposed in 1961 but not enacted until 1962, largely because of the misgivings and often hostility of both the business and labor communities. (Either because of its novelty or because of its form, the investment tax credit was at first opposed by many business leaders. Secretary Douglas Dillon was fond of telling the story of a man who asked him to explain it, step by step, and at the end added, "One last question: Why am I against it?")

Second, the liberalization of tax depreciation guidelines.

Third, the "monetary twist," designed to make funds available for long-term investment and decrease long-term interest rates, while holding up short-term rates to cut outflows of funds overseas.

Fourth, the bolstering of worker training and retraining programs.

Fifth, the development and introduction of the wage-price guideposts to help ensure that stimulative measures would not run off into wage and price inflation.

Sixth, and perhaps least well recognized, the decision in late 1961 to go for the "Cambridge-New Haven Growth School" formula of holding off on tax cuts in the hope that the economy could struggle up to full employment under the then existing burden of taxation and thus produce a full-employment surplus. The purpose? To channel funds from consumption to investment via the debt repayment that would provide funds for private capital formation.

Let me pause here to note two oft-misunderstood points. The first is that while the supply-side effects of tax cuts on work effort and on saving are murky at best, there's no doubt that running a surplus at full employment would have salutary supply-side effects. Let me be more specific:

The evidence does show an impressive investment response to sharply targeted measures like investment tax credits and more liberal depreciation.

• But on work response, the evidence is ambiguous. Countless studies show that existing workers' responses to tax cuts are an amalgam of (a) added work by some—the "eager beavers"—as they keep a larger proportion of their rewards for work effort and thus see the cost of leisure going up; (b) no change by those who are locked into a pattern of fixed hours; and (c) reduced work by those laid-back members of the labor force who ease off because they can now achieve their income-after-tax targets with fewer hours of work. Contrary to loose—but ever-confident—assertions by some supply-side economists, painstaking research has not yet established for sure even the sign—plus or minus—of workers' net response, let alone the magnitude. (Studies do show a significant positive response of labor effort by spouses and other second earners to increases in take-home pay.)

• Similarly, on savings, we are not sure which response dominates: to save *more* in the light of lower taxes on savings or to save *less* since lower taxes enable the saver to achieve a given target living standard with less saving. Most economists would agree that, on net balance, there is a modest positive response of saving to tax cuts, especially at the outset.

• We do know that when governments cut their deficits or run surpluses in a high employment economy, *that* constitutes net saving (that is, either reduced dissaving or positive saving) and releases funds for business investment and housing, provided the monetary authorities do not offset the effect by single-minded pursuit of the wrong target.

The second point is that although President Kennedy sought some significant expenditure increases from Congress, both for social programs and defense, his batting average on civilian programs was not high, and total defense spending as a percentage of GNP declined steadily during his administration. I underscore the latter point because the idea that he got the economy moving again through a defense buildup is a canard that dies mighty hard.

Recently, a *New York Times* guest columnist confidently asserted that "the higher growth rates of the 1960s were achieved only after President Kennedy succeeded in persuading Congress that, in light of the Berlin crisis, defense spending should be increased by 50 percent." In *absolute* terms, national defense expenditures rose less than 10 percent in the early sixties, from $46 billion in 1960 to $50 billion by 1965. More important, in *relative* terms, defense outlays actually fell as a percentage of GNP, from 9 percent in 1960 to about 7.5 percent in 1965, just before escalation in Vietnam. So much for the notion that defense powered the 1961-65 expansion.

The tax cut: the demand-side follow-through

The shift to demand-side economics came in 1962 when it became painfully apparent that the overburden of taxes was so heavy that the economy could not achieve prosperity under its yoke. Alas, the Cambridge-New Haven hope for full employment surpluses had to go by the boards. With economic expansion faltering in 1962, with Congress in no mood to provide economic stimulus from the budget-spending side, and with top individual income tax rates still at 91 percent—far too high—we launched the offensive for a big tax cut in March of 1962. Its main purpose was to step up the pace of expansion and bring the economy up to its full-employment potential.

From March 1962 on, the Council campaigned for a $10 billion, later a $12 billion, tax cut. The Treasury was initially willing to go along with $3 or $4 billion of it, mainly to facilitate tax reform. But it was not until we hammered out an agreement in the Cabinet Committee on Growth late in 1962 that the President adopted the $12 billion tax cut goal.

The tax cut's nine-month White House gestation period was then followed by 15 months of labor in Congress. To be pushing a large tax cut in the face of a sizable deficit and a rising economy was unprecedented. It was a rocky road. I remember all too vividly in early 1963 when Congresswoman Martha Griffiths asked me, at a Joint Economic Committee hearing, why the American people were so loath to accept a tax cut. After I suggested that it might just be their Puritan ethic, Congressman John Byrnes of Wisconsin let me have it: "I'd rather be a Puritan than a Heller."

Fairly early in the game, the President had to drop much of his reform package in order to clear the track for the cut itself. And much of the Kennedy Cabinet voiced only lukewarm support (and some, privately, opposition or apprehension) lest the tax cut deprive them of revenues needed for their programs. That it would stimulate the economy and provide a sounder basis for later increased appropriations was not an easy case to sell.

That calls for another word about the bizarre notion that a tax cut will pay for itself by so stimulating supply (work, savings, and investment) that the reflow of tax revenues will match the initial tax loss. When an economy is operating far below its potential, as in the early 1960s, a tax cut's demand-side effect boosts purchasing power and puts both idle machines and factories and idle workers back to work, thus broadening the tax base—not enough fully to pay for itself, but enough to cut the revenue loss very significantly.

The notion that a tax cut's prompt demand stimulus, let alone its long-delayed supply stimulus, could generate enough revenue to pay for itself is unfortunately not supported by the statistical evidence. (Once, in an exuberant response to a leading question by the late Senator Hubert Humphrey, then Chairman of the Joint Economic Committee, I suggested that the tax cut had paid for itself; but on more careful inspection of the evidence, I publicly recanted later in a letter to the *Wall Street Journal*.)

In any event, the tax cut—20 percent for individuals and, in combination with the earlier tax breaks for business, 20 percent for corporations—

became law after President Kennedy's death. To a remarkable degree, it "delivered the goods" until it was overtaken by Vietnam events:

- Enacted in March, 1964, it stimulated a more vigorous expansion of the economy and reduction of unemployment without agitating inflation. The specific numbers: by July of 1965 (just before escalation of the war in Vietnam), the unemployment rate had dropped to 4.4 percent, while the consumer price index was rising at a rate of only 1.5 percent per year.
- Dropping top individual tax rates from 91 percent to 70 percent helped to weaken somewhat the incentives for tax avoidance and strengthen the incentives for investment, while easing of low-bracket rates and tightening of the capital gains tax helped improve the equity of the tax structure.
- In a two-track policy emphasizing both demand and supply stimulus, the combined tax cuts gave a powerful boost to demand while at the same time providing strong incentives to increase risk-taking and enlarge the flow of investment funds. In point of fact, the ratio of private investment to GNP reached a new postwar peak in 1965.
- As later events proved, the surest path to more adequate financing for government programs was, paradoxically, through tax reduction. With the acceleration of expansion through the tax cut, the economy soon returned to full prosperity. Both the atmosphere thus created and the resulting generous flows of federal, state, and local revenues led the country to a more sympathetic attitude toward expansion of government social programs. As President Kennedy put it in a conversation just 11 days before his death, "First we'll get your tax cut, and then we'll get my expenditure programs." And on November 19, he assured me that a direct attack on poverty would be part of his 1964 program. The 17 percent rise in GNP in the two years after the tax cut—between the first quarters of 1964 and 1966—made possible a 13.5 percent rise in government spending at lower average tax rates.

The tax cut proved the flip side of the Kennedy dictum that success has a thousand fathers, but failure is an orphan. In a perverse way, I treasure an April, 1964, release by the American Taxpayers Union of New Jersey assuring one and all that it had "planned, initiated, and spearheaded the crusade that resulted in the recent [federal] tax cut." Showing a nice sense of proportion, it went on to note its support of legalized off-track betting.

Successful as the tax cut was, one has to add a disappointing postscript. When, with Vietnam, the time came for President Johnson and the Congress to turn the "New Economics" around—to use tax increases to cut aggregate demand and subdue inflation—the political process was found wanting. It was not until mid-1968 that a tax increase was finally enacted. Meanwhile, the superimposing of some $25 billion per year of Vietnam expenditures on an economy already programmed for full employment had done its malevolent work, overheating the economy and letting the inflationary tiger out of its cage.

Against the great human and political tragedy of Vietnam, the economic cost may not loom so large. But without that tragic war, I doubt very much that we would have been blown so far off the course of economic-growth-with-price-stability on which President Kennedy had set us in his exhilarating thousand days.