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CHALLENGE INTERVIEW

Taxes and the State of the Economy

WALTER W. HELLER

► *Few economic policy issues have stirred as much discussion as the $12 billion tax cut recently passed by Congress. With the exception of Presidents Kennedy and Johnson, no one is more closely identified with the tax cut than* DR. WALTER W. HELLER, *Chairman of the Council of Economic Advisers. In this interview with Dr. Heller, the tax cut is re-examined, with emphasis on the effects it might be expected to have on economic growth, productivity, price stability, employment and most other aspects of the current and future economy.*

Q DR. HELLER, *would you tell us briefly why a tax cut was deemed necessary by the Kennedy and Johnson Administrations?*

A Simply put, the market economy really has no self-regulator that brings the demands of our myriad households, businesses, and state and local governments into balance with supply *at full employment*. Sometimes demand is too strong, sometimes too weak. Since 1957 we have had continued slack, continued inadequacy of demand. This is not just a cyclical matter since it has been continuing for seven years, in spite of very substantial expansion in the past three years. We are still producing $25 billion to $30 billion below our productive potential. In these circumstances, the tax "take" was set too high.

Q *What, then, is the theory behind the tax cut?*

A At full employment, or, let us say, four per cent unemployment, the revenue generated by our federal tax system (before the recent changes) would have exceeded federal outlays by $8 billion to $10 billion. That drain on total demand—that fiscal overburden, if you will—has been holding the economy back from achieving full employment and from realizing that potential surplus. Of course, had private demand been strong enough to get us to full employment in spite of the high tax drain, the surplus would have been appropriate. But in the present case, the great postwar surge of demand had ebbed, and this kind of a surplus became inappropriate. We should not forget that the federal tax system generates about $5 billion to $6 billion a year more revenue each year than it did in the previous year, if production expands enough to maintain the same degree of employment. And unless federal expenditures keep pace, plain arithmetic indicates that the tax system develops a drag on growth. So the rationale of the tax cut was to stimulate private demand and private incentives by releasing about $12 billion a year of revenues. I may say, parenthetically, that the $12 billion figure is in terms of 1963 income levels; in today's terms the tax cut is perhaps closer to $13 billion. The objective of the tax cut was to release that amount of before-tax income, in order to boost private investment demand and private consumer demand. And on the basis of past experience and of past relationships between income and savings, consumption and investment, and so on, the $13 billion will be multiplied into a total stimulus to demand and gross national product of perhaps three times as much as the tax cut itself.

Q *President Johnson, in his annual "Economic Report" to Congress, stated, "the tax cut will speed our climb toward our goals of full employment, faster growth, equal opportunity, balance in our external payments and price stability." Taking these goals in order, Dr. Heller, would you explain, please, how the tax cut will affect unemployment?*

A Our best judgment is that the tax cut, in the process of generating $30 billion to $40 billion of additional production, will generate two to three million additional job opportunities. This represents a fairly wide range of estimate, but I think the central point is that as we expand both consumption and investment, additional jobs will be created throughout the private economy.

Q *How will the tax cut promote faster economic growth?*

A The tax cut will provide, on one hand, a stimulus to modernization and cost cutting—in other words, an increase in productivity, in the amount of output we get from each unit of input. And secondly, by pushing output closer to capacity, it will create a new stimulus to expansion of capacity. Thus, both by the rise in productivity and by the increase in the rate of investment in plant and equipment, the tax cut will speed economic growth.

Q *How will the tax cut increase equal opportunity?*

A If you recall the Freedom March in August, 1963, the banners read, "Jobs *and* Freedom." That struck me as particularly appropriate. When you have strong job opportunities, the inequalities and discrimination in employment tend to diminish—the people who are most hurt by unemployment get the greatest benefit. When the unemployment rate as a whole drops by one percentage point, the unemployment rate for Negroes drops two percentage points. Likewise, the skilled machinist who is colored and is today driving a cab can find a job as a machinist when labor is scarce. That is one side of it. The other is simply that the higher levels of income generated by stronger job opportunities will enable people to get better education, will provide incentives to employers to put in on-the-job training programs, and so forth. All of these provide greater equality of opportunity.

Balance and stability

Q *How will the tax cut improve the balance of payments situation?*

A To answer this question, we have to look both at the trade effect and the international capital flow effect. On the trade side, there will, of course, be some stimulus to imports. At the same time, however, the tax cut should improve the international competitive position of United States products insofar as it stimulates modernization and results in lower costs. So far as the impact on the flow of capital is concerned, this can be one of the most important aspects of the tax cut. As it increases profits and the rate of return on capital *in* the United States, it tends to hold capital here instead of having it flow overseas. We would expect this to be one of the most significant factors in the contribution of the tax cut to an improved balance of payments position.

Q *How will the tax cut help to maintain price stability?*

A As I have already mentioned, it will, both directly and indirectly, contribute to reduction in costs through incentives for investment, through the stimulation of further investment by providing more cash flow, and so on. To that extent, and to the extent that it satisfies income claims—both by wage earners and by stockholders—without increasing wages and prices, the tax cut will make a contribution to price stability.

Supply and demand

Q *Every time there is a sustained upturn in the economy, there are those who become worried about inflation. In your judgment, does the impact of the tax cut offer any real inflationary threats?*

A I feel that a sober and balanced reading of the economic facts and prospects today gives us a good deal of reassurance on the depth and breadth of our defenses against inflation. Let's look first at the supply side—in other words, the margin of resources available to meet this stimulus to consumer and investment demand. We have four million people unemployed and a large number of "hidden unemployed," probably adding up to a million or more, who will be drawn into the labor market when jobs are ample. Likewise, there are many who are employed only part time but would prefer full-time work. Further, we will average one and one-third million net additions to the labor force each year in the next few years. Roughly two million workers are displaced each year by rising productivity, by technological advance, and so forth. In other words, we have a great and growing supply of labor.

Now, looking at industrial capacity, we are using only about 87 per cent of our industrial capacity, on the average, against the preferred operating rate of 92 per cent. And we are constantly increasing capacity. We have made industry-by-industry breakdowns, and we cannot, in the 15 important industries we have studied, find a single one where the relationship of expected sales to expected capacity in 1964 will generate bottlenecks. Along with this is a good supply of raw materials.

In other words, it seems to us that we have a good supply situation, and we don't think that the increase in demand under the tax cut will exceed the reasonable limits established by the supply situation I have just described.

Q *Does this mean there are no dangers?*

A Not at all. Whenever there is a strong demand situation and sustained expansion, there are temptations to increase prices and to move wages ahead faster than productivity. And it is because of those temptations that the President has particularly underscored the wage-price guideposts—that is, the standards by which labor and management are asked to observe the public interest in noninflationary wage and price decisions.

Q *Aren't you afraid, Dr. Heller, that an investment boom might possibly develop? In that event, what steps can we take to control this kind of development?*

A You are, perhaps, referring to the 1955-57 type of situation, when an investment boom generated inflation in that sector which then spread to other sectors. Today's situation is quite different. We are expecting a 10 per cent rise in plant and equipment investment in 1964 over 1963. But in 1956 we had a 22 per cent rise in one year (in current dollars). I think that we are in a position to accommodate the kind of advance we foresee this year from the fourth quarter of 1963 to the fourth quarter of 1964. Even with the very favorable investment outlook, it is not likely that the year-over-year increase in investment will be more than $2 billion greater than last year. It seems to me that our investment goods industries will be able to accommodate that without inflating their prices.

Neither riskless nor reckless

Q *Can you tell us, Dr. Heller, whether the discipline of economics is in a position today to control the timing of steps to counteract inflation? There is the risk of dampening the economy prematurely or of not acting quickly enough.*

A What you are pointing out is that one lives dangerously in the field of economic policy. One inevitably takes some risks, but I would say that we are not limited to a choice between being riskless and being reckless. To incur some risks in the course of achieving great gains is not a reckless procedure. One of the risks is the imperfection of this discipline, or this science—or perhaps we should call it this art—of forecasting. Nevertheless, the tools of forecasting and particularly of measuring the current development of the economy have been very substantially improved, so that we can detect movements and changes more quickly than we used to. Indeed, we are currently developing a better system—we call it a "distant early warning system"—for observing potential price movements, and so forth. Side by side with this, one must recognize that there are some policy measures that can move very quickly. Monetary policy can respond rapidly when inflation appears on the horizon. So, on the one hand, we are improving our measurements and, on the other hand, we would not be defenseless if and when the signs of inflation appear.

Q *Some critics of the tax cut point out that the full effects of reduced government spending will be felt in calendar 1965, presumably at the very time that the momentum of the economy's expansion will be petering out. Would you comment on this, Dr. Heller?*

A Yes, I think it misses the main point, which is the rhythm of response, if you will, to the tax cut. The economy will be riding the crest of the tax cut wave well beyond 1964. This wave will be a more or less gently rising swell. The total impact of the tax cut will not be felt immediately. Some of the consumption impact will be delayed, and more of the investment impact will be delayed. So rather than having a tidal wave in 1964 which will recede in 1965, this swell will continue into 1965. That is, it seems to me, the central point.

A second point should be made—namely, that *if* the impact of the tax cut relative to our economic potential is less than expected, then, of course, the fiscal program presented next January can be adjusted accordingly. We do not have an inert and helpless budget policy, but one that can be adjusted to the developments that occur.

Q *Does a tax cut at a time when the economy is still expanding represent a new policy approach to fiscal theory?*

A It is not a new fiscal theory, but it does represent a breakthrough for the American people and the American Congress to follow this particular fiscal approach. The Committee for Economic Development, for example, urged—as early as 1947, in its first major fiscal policy statement—that tax cuts should be made from time to time to remove the fiscal drag. That is, as this powerful tax system generates revenues which begin to pull the economy back, it has recommended that there be tax cuts to remove that drag. So the theory is not new.

What *is* new is that the principle is now being built into a coherent government policy to maintain expansion, to speed long-term growth and, of course, in the process provide some insurance, important insurance, against the recession that past history might lead us to expect somewhere along this time in the business cycle. To sum up, it is not a new approach to fiscal theory, but it is a new adaptation as part of a balanced government economic policy. And I think there is a new acceptance of it on the part of the American people.

Deficits due to recession

Q *To a good many people, any kind of budgetary deficit has an immoral overtone. They feel uneasy about it, which prompts me to ask you, candidly, are there any limits in budget deficits beyond which it is dangerous to go?*

A Let me make two comments on that. First, let me, for a moment at least, change your term "budget deficit" to "fiscal stimulus." Undoubtedly, there are limits to the amount of fiscal stimulus that it is safe to give an economy. The stimulus in this tax reduction is designed as carefully as the imprecise science of economics will permit. It is designed to fit the underemployment and underutilization of industrial capacity in the American economy. In other words, it is designed to fill the gap between actual and potential production. The purpose here is to get a tax cut that will express itself in higher production, more jobs, higher real income and profits, and not in higher prices. So, yes, of course, there are limits beyond which you don't want to go—limits beyond which tax cuts would run to waste in price increases.

Second, as to the deficits themselves, one point that is often overlooked or underemphasized is that most of our deficits in the postwar period have been the result of slack, of recession, of falling short of our economic goals. Just think of the fiscal 1959 deficit, which was originally programed as a half-billion dollar surplus and came out a $12.5 billion deficit. That certainly wasn't planned. It was the result of recession.

Today, the tax cut is temporarily generating a large deficit. But that's not the point of the exercise. What counts is the stimulus to demand and incentives by raising after-tax personal and business incomes. By generating more income, jobs and profits, a larger tax base will be created, and this will give us our best chance for a balanced budget in a balanced economy.

Economic and political considerations

Q *Dr. Heller, planned deficits, or, to use your term, fiscal stimulus, can be achieved either by a tax cut or through increased federal spending. Why did the Administration choose the tax cut?*

A There are really two sets of reasons: one that relates to the tax side and one that relates to the expenditure side of the budget. On the tax side, a restructuring of the income tax was long overdue, both to reduce whatever distorting or disincentive effects the income tax has and to build in as much reform as possible. On the expenditure side, it is perfectly true that there are many unfilled needs. But there were both economic and political considerations that made the expenditure route inadvisable in 1963-64. On one hand, there had already been roughly an $18 billion increase in expenditures during the Kennedy Administration, which had provided a strong stimulus to the economy. Secondly, there are speed limits, again, that have to be observed. I think that anyone who has worked closely with the government expenditure process would agree that to expand civilian government programs by $5 billion or $10 billion both quickly and efficiently is, at best, mighty difficult—unless it is simply done by a series of transfer payments.

And then there is, of course, the point that has been developed in modern economic theory that compensatory action by the government to offset deficiencies in demand in the private economy should not take place primarily by moving expenditure program levels up and down. These levels should, by and large, be determined by long-run considerations of what is the most efficient and desired balance between public and private use of resources. Adjustments for compensatory purposes should take place primarily on the tax side.

Finally, the American people and the American Congress plainly have a preference today for providing this stimulus through the private market mechanism rather than through enlargement of government programs. In short, this is a case where tax economics, expenditure economics and political reality all generated a preference for the tax cut rather than the expenditure increase route.

Insufficient aggregate demand

Q *To what extent do you believe that our present rate of unemployment is due to inadequate demand, to structural causes and, last, to frictional causes?*

A This is, of course, a question on which there is a very considerable amount of controversy. It is our conclusion, on the basis of very careful study of structural and frictional factors, that the primary cause is a lack of aggregate demand. Let me demonstrate why we reached this conclusion. In a positive sense, it is the experience of the past three years. In the first five quarters of economic expansion, from the first quarter of 1961 to the second quarter of 1962, real gross national product was expanding at a rate of seven and a third per cent, unemployment dropped from seven per cent to five and a half per cent, capacity utilization went up from 77 to 86 per cent. In the ensuing period, since the spring of 1962, the unemployment rate has been stuck at five and a half per cent and capacity utilization has hardly moved up, even with an expansion rate of nearly four per cent of gross national product in real terms. This strongly suggests that when GNP, or total demand, is expanding fast enough, we make real inroads on unemployment and real inroads on unused capacity. Four per cent is a fine rate of expansion if you are once at full employment, because it obviously enables you to hold your own, which is what we have been doing. But it does not enable you to absorb the unemployed.

On the negative side, we have tried to determine whether there is a real change in the structure of unemployment. A careful sifting—both by us and by independent scholars like Otto Eckstein at Harvard and Albert Rees at Chicago—does not reveal a significant change in the *structure* of unemployment since it last was at four per cent. And indeed geographical differences in unemployment rates, contrary to popular conception, have actually decreased.

At the same time, let me assure you that we give full stress to the need for better education, better training and better programs to increase the skill structure and mobility of labor so that the two attacks can work together—the structural improvements and the increased aggregate demand.

Q *Can you explain, Dr. Heller, as simply as possible, what is meant by the multiplier effect?*

A The multiplier effect is the process of cumulative expansion or contraction that results from the fact that, first, each man's income affects his own spending, and second, one man's spending affects another man's income. Thus, a given increase in spending, as from the tax cut, will have a magnified effect on total output and total GNP. (This assumes, of course, that idle resources are available. If they weren't available, then this magnified—or multiplied—effect would simply express itself in inflation.) GNP goes up not just by the amount of the initial increase in demand by the people who get the tax cut, but, of course, by the increase in demand by those whose incomes rise as taxpayers spend their larger incomes for durable and nondurable goods, services, and so on.

Beyond the multiplier there is the accelerator, because as people spend more, businessmen have to stock more inventories, which is one form of business investment, and they have to expand plant and equipment, which is another form. This releases further purchasing power, and the process takes place all over again. That is the basis for my earlier estimate that the $12 billion tax cut will translate itself into more than $30 billion of additional demand and output.

Working toward full employment

Q *During recent decades our periods of economic recovery following recessions have tended to peter out before full employment was reached. Do you believe the recent tax cut will provide enough momentum to carry us to full employment?*

A Achieving and maintaining full employment in the face of the tremendous numbers and rapid growth of available workers is a very difficult policy assignment. We think that the tax cut is well designed to start us toward this goal. But it would take a brave man to say that it will solve the problem for all time.

Q *It is premature to ask you to assess the full effects of the tax cut. But what effects would you be willing to suggest the tax cut has already produced?*

A You are quite right that it is much too early to say that one can measure the impact of the tax cut. Yet we already have some indications that are significant. We are in the 38th month of an expansion that has already broken all peacetime records (except for the four-year climb-out from the Great Depression—an expansion which ended with 14 per cent unemployment and is hardly comparable). So we are on new ground. This new ground includes stated plans for a substantial rise in investment in plant and equipment this year—when we are well along in an expansion. It also includes optimism reflected in consumer surveys. This gives us indicative evidence that the tax cut is having a buoyant effect on the economy. I hope that economic research, this year and next, brings us more measurable evidence. A year from now, I would hope to have a "harder" answer.

Q *While most economic indicators tend to suggest continuing prosperity for the immediate future, what forces or factors, if any, do you foresee that might impede continuing expansion?*

A At the moment, of course, the outlook is generally favorable on all fronts. But economic policy always has to be ready for shocks, surprises or changes in direction. I don't foresee this kind of trouble, but first would be the possibility of a worsening balance of payments position, or an outflow of funds that would require monetary tightening in order to stem or reverse it. Second would be the development of more inflationary pressures than we anticipate, which again would, as in the first instance, call for monetary tightening. The possible appearance of excessive price and wage increases, a resumption of a wage-price spiral—which is very difficult to single out by monetary policy—might be another kind of development that could slow down the expansion. Another possible problem would be the relaxing of cost consciousness and close inventory control by business. But basically, I think you can see that I don't really expect any major impediments to expansion in the reasonably foreseeable future. After a seven-year lag, we are coming within striking distance once more of the maximum employment, production and purchasing power called for by the Employment Act of 1946. But as we do, I think it is very important for policy makers, and indeed for the American people in general, to keep in mind that we want to achieve these goals side by side with a minimum of price instability, a minimum balance of payments deficit and, above all, a minimum of poverty and economic inequality.

Q *Thank you very much, Dr. Heller.* ■