

THE 1967 BUDGET AND THE POSTWAR ECONOMY

DONALD J. HARRIS, Assistant Professor of Economics

If the main characteristic of the Johnson presidential era can be regarded as the politics of consensus, then the 1967 budget proposals may well prove to be the foremost example of this kind of politics. The budget, as the Wall Street Journal aptly described it, "offers a little something for everyone."

Specifically it provides \$10.3 billion—a 100 percent increase over this year's spending—to "meet the costs of opposing aggression" in South Viet Nam, as well as a (smaller) net increase of \$3.2 billion to advance "Great Society" programs in such fields as health, education, poverty, housing, and community development.

Some cuts are provided as partial offsets to the increases. The controversial farm program is to be cut from \$4.3 billion to \$3.4 billion. Spending on space research and the often questioned race to the moon will undergo a token reduction of \$0.3 billion. Economies and improvements are to be sought in the operation of government. A gesture is made towards reducing the balance of payments deficit by a slight cutback in certain types of federal overseas payments. And were it not for the "special Viet Nam costs," we are told, total "regular" administrative budget expenditures would rise by only \$0.6 billion, thereby holding the line on the total size of the budget.

Despite the higher spending, the deficit in the administrative budget is supposed to fall sharply from \$6.4 billion to \$1.8 billion, the smallest in seven years. All this is to be achieved with only a small, temporary increase in taxes, without increasing the rate of inflation, and without impairing steady economic growth. Finally, we are assured of sufficient flexibility so that if "efforts to find peace in Viet Nam prevail" the funds spent on "guns" would be transferred to "butter."

These ingredients are no doubt designed to make the budget politically acceptable in an election year, and with his powers of persuasion, the President is likely to have little difficulty getting his proposals through the Congress. Let us therefore try to evaluate the main ingredients of the proposals and the overall impact of the budget on the economy.

Military Programs Are Dominant

It is difficult to assess at this time the possibility of realizing some of the main objectives set out in the budget. On the expenditure side, the largest uncertainty surrounds the scale of the war in Viet Nam. In addition to the provisions in the 1967 budget for financing the war, \$12.8 billion in supplementary appropriations have been requested for the fiscal year 1966, but not yet enacted. Whether these amounts will prove deficient or excessive depends on the future course of the war.

During the height of the Korean conflict, military expenditures rose by more than \$20 billion between fiscal years and actual expenditures fell somewhat short of budget estimates. At the moment it is anybody's guess as to what the outcome in Viet Nam will be in the near future, although the provision of such large and increasing sums for pursuing the war may seem inconsistent with the fanfare of a "peace offensive." If the "hawks" prevail and the further intensification of the war predicted by some observers materializes, we might expect even higher expenditures in this area.

National defense continues to make up the largest single item of expenditure (see Chart 1). Outlays of

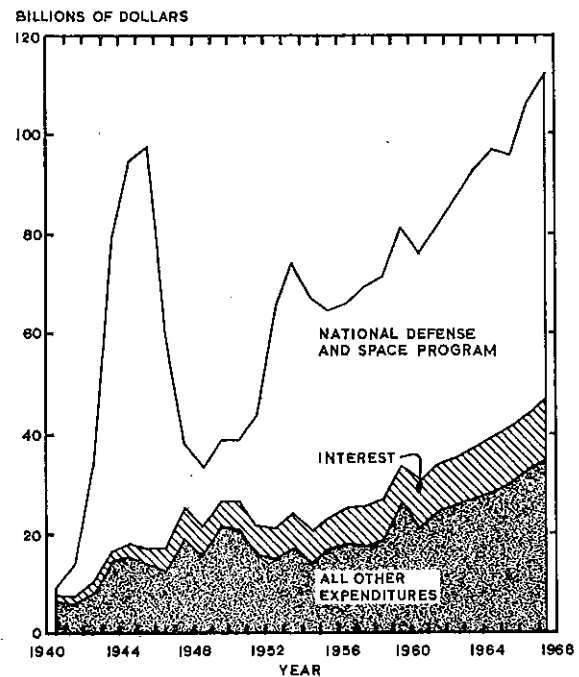
\$60.5 billion for 1967 represent a \$4 billion increase over 1966 and about 54 percent of the administrative budget total. Excluding the special Viet Nam costs, the figures purport to show a projected net decline of \$1.7 billion in "regular" national defense payments. The decline is attributed mainly to the elimination of unessential forces and installations and general improvements in the efficiency of the defense establishment.

Undoubtedly the cost reduction program begun in 1961 and vigorously pursued by the current Secretary of Defense has been a successful one so far. But as the budget message explicitly admits, the rising Viet Nam costs have only led to a postponement of other military programs involving expansion of strategic and conventional war forces. No substantial reduction in these items is projected for the near future, despite the continued formality of disarmament talks at Geneva. No doubt the proportion of total defense spending going to "research and development" (about 10 percent) has produced some side-effects in the form of improved knowledge of peaceful uses of nuclear energy and other advances in nonmilitary technology. But the continued large size of the overall defense program seems to be based on cold war premises and priorities that become increasingly outmoded.

Other sources of uncertainty about the size of programs also persist. As to the proposed cutback in the farm program, for example, it remains to be seen whether a substantial reduction in agricultural subsidies can be achieved. Previous administrations have usually retreated from a confrontation with the powerful vested interests in the agricultural sector. Besides, once authorized, these programs are not subject to control by the Administration.

CHART 1. COMPOSITION OF ADMINISTRATIVE BUDGET EXPENDITURES

(By fiscal year)



Source: Bureau of the Budget and Council of Economic Advisers (1966 and 1967 estimated).

Strategy for Budget Adjustments

The projected rise in expenditures is to be financed by increased revenues, which are expected to come partly from new or increased user-charges on transportation facilities, certain reforms in tax collection procedures, and a reinstatement of excise taxes on passenger automobiles and telephone service. The rest is to come from the projected overall growth in income.

The projected level of expenditures on a national accounts basis (the most comprehensive measure of the economic impact of the federal budget) is \$142.7 billion, an increase of \$11.7 billion or a billion less than the rise estimated for the current fiscal year. Receipts are expected to increase by \$13.4 billion (to \$142.2 billion), exceeding the estimated 1966 rise by about \$4.2 billion. The resulting deficit would therefore amount to only \$0.5 billion on this basis.

Not much can be said about the possible margin of error in these estimates. However, that total revenue from these sources will be sufficient to limit the budget deficit as anticipated may well be wishful thinking if the costs of the Viet Nam war turn out to be underestimated. The objective of limiting the deficit could then be maintained only by reducing further the rate of advance in "Great Society" programs or by increasing tax rates. The former alternative would no doubt be politically more attractive, although the latter is held out as a possible choice. In any case, this feature of the budget seems to contain more than the usual amount of optimism.

In general the proposed strategy of adjustment indicates the underlying intention on the part of the policymakers to exert a mild degree of restraint on the economy, at least relative to the current expansionary phase. This objective seems quite consistent with the increase in the discount rate by the Federal Reserve Bank in December, despite the uproar which was made on that occasion.

The objective of mild restraint is presumably guided by fears of serious inflationary pressures which might arise as continued expansion of activity under the stimulus of greater government spending takes up the slack in the economy. It should be noted that this is a fear based on potential rather than actual price increases, since the consumer price index registered only a 1.7 percent increase on an annual basis in 1965, although the monthly change in December was somewhat sharper than usual. By contrast, prices rose by 3.5 percent in the first year of the Korean war and by 2.7 percent in the expansion of 1956-57. There are obviously questions here also: At what point does inflation become "serious?" Should other goals be sacrificed in an attempt to avoid inflation? These are left unanswered in the budget.

The fear of inflation implicitly assumes that price increases are induced by demand pressures when the economy is operating close to capacity (however defined). Whether the economy as a whole has yet, or will have in the next year, exhausted available capacity is very much in doubt. The McGraw-Hill index of capacity utilization for the fall of 1965 showed a decline of about one point (to 87 percent) from the previous fall. With "preferred capacity-rates" of 92 percent and total capacity expanding at about 5 to 7 percent a year, it would take a considerable jump in demand to push the economy against the ceiling. This is so even though the unemployment rate is now down to 4 percent. Moreover, the experience of the 50's showed that inflation is not only, nor even primarily, caused by demand pressures, but also by price-fixing in oligopolistic industries and the effects of the wage-bargaining process. The budget message contains no plans

to deal with these problems apart from the much touted "wage-price guideposts." The inflation fears may themselves be taken as an acknowledgment of the ineffectiveness of the guideposts.

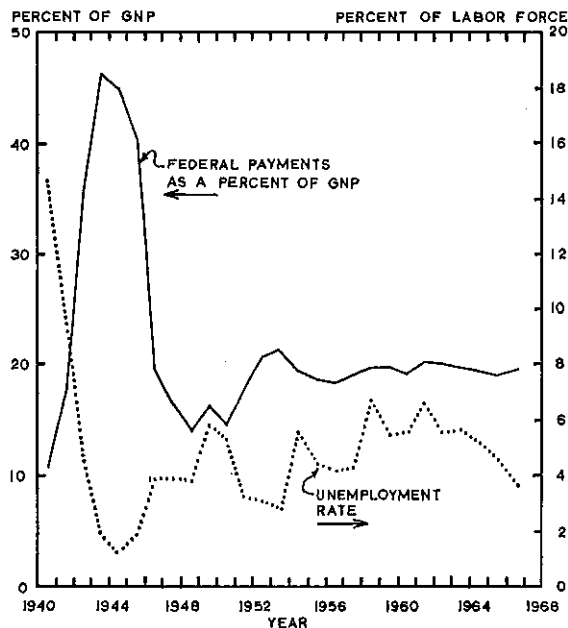
The "New" Role of Economic Policy

The current expansion has been variously described as "the greatest upsurge in economic well-being in the history of any nation" and the "American economic miracle." Quite apart from the hyperboles, the record shows a continuous and, relative to the immediately preceding years, high rate of growth of GNP in real terms, averaging 5 percent per year, with individual components such as personal income, consumption, and profits showing similar gains. Unemployment declined from a postwar peak of 7 percent in the spring of 1961 to the current level of 4 percent, and relative price stability was maintained throughout the period.

This record has been thought to demonstrate a newly acquired ability of the American economy to undergo "sustained balanced growth in peacetime" and, further, to vindicate fiscal and monetary policies recommended by Keynesian economic analysis. Former Secretary of the Treasury Douglas Dillon summed up this view when he pointed out that "these years encompassed perhaps our most significant advance in decades in the task of forgoing flexible economic policy techniques capable of meeting the needs of our rapidly changing economic scene."

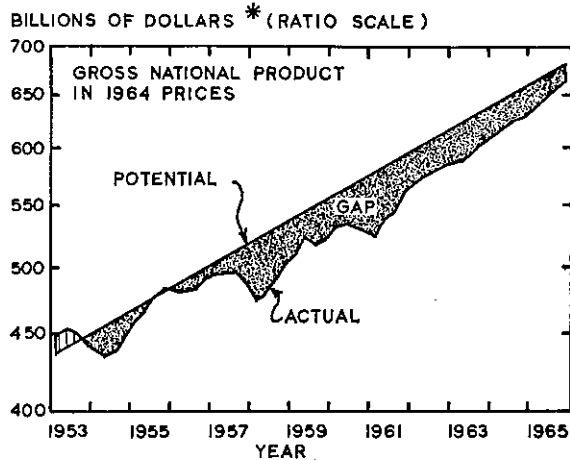
As is well known, this flexible policy calls for the incurring of budget deficits in times of recession either through increasing government expenditures more than revenues or reducing revenues more than expenditures, aided by "easy credit" conditions in the monetary sector. The consequent increase in national income is predicted to be some multiple (greater than one) of the original budget deficit. Similarly a rise in the total level of the budget may have a stimulating effect even with no change in the deficit.

CHART 2. THE UNEMPLOYMENT RATE AND FEDERAL PAYMENTS AS A PERCENT OF GNP



Source: Bureau of the Budget and Council of Economic Advisers (1966 and 1967 estimated).

**CHART 3. GROSS NATIONAL PRODUCT,
ACTUAL AND POTENTIAL**



* Seasonally adjusted annual rate.
Source: Council of Economic Advisers.

The fairly rapid recovery from the downturn of 1960-61 and the subsequent expansion can be explained, in part at least, by the favorable response of the private sector to a well-timed series of such economic measures, starting in 1962 with more liberal depreciation allowances and an investment tax credit for private business and culminating in the overall tax reduction of 1964. These were accompanied by continuing administrative budget deficits ranging from \$3.4 billion to \$8.2 billion and a rise in the national accounts budget from \$98 billion in 1961 to this year's estimated level of \$131 billion — a trend which the new budget indicates will continue into next year, although with a smaller deficit.

It now seems clear, however, that the impact of the earlier measures, and particularly that of the 1964 tax cut, had tapered off by early 1965. Some additional measures for economic stimulation became available in the second half of the year, but the major further impetus for expansion came with the announcement of escalation in the Viet Nam war. The speed-up in procurement became apparent in new orders to the armaments industries and other military suppliers in the summer months.

We are now told by the Commissioner of Labor Statistics that the expected expansion of the armed forces by about 300,000 during this year will almost equal the anticipated addition to the labor force of men aged 20 and over, and the Council of Economic Advisers predicts a reduction of the unemployment rate to less than 3.75 percent by the end of the year. If this prediction proves correct, then this will mark the first time since the Korean war (and before that, World War II) that the unemployment rate has fallen below 4 percent (see Chart 2).

In looking at the current and past record, it may be of some significance that the occurrence of peak rates of employment and production in the American economy during the period since 1930 has coincided with rapid increases in government spending due to a war effort (with the possible exception of the rather feverish durable goods boom of 1955-57). From the nature of the evidence it would appear that fiscal policy techniques have been most successful in terms of their impact on unemployment, excess capacity, poverty, and so on, during wartime.

In general, it is also true that peacetime counter-cyclical policies (both those of a discretionary nature as well as the "automatic stabilizers," i.e., corporate profits, transfer payments, and personal taxes) have been instru-

mental in reducing the severity of postwar recessions by bolstering personal income and spending during the downswing. Such policies have also worked to increase the duration of the expansionary phase of postwar business cycles.

However, one should note that an equally, if not more, important buffer throughout the period was the high and increasing level of government spending on defense and space research, supported by the stabilizing behavior of certain components of private long-term investment (mainly construction). Moreover, the three upswings since the Korean war (including the recent one, prior to escalation) proved insufficient to erase the excessive unemployment and idle capacity with which they began, and the gap between potential and actual output has remained on average above 4 percent (see Chart 3).

Beyond the War Economy

The causes of the chronically high unemployment rate experienced since 1954 have been intensely debated in recent years. Some observers have sought to explain the phenomenon in terms of "structural factors" in the economy such as regional and occupational immobility, barriers of sex, race, health and age, and imperfect knowledge of job opportunities. Although this view may have some validity in the sense that structural rigidities appear in the labor market during prolonged periods of depressed conditions, it seems to be somewhat misguided in view of wartime experience and the recent and continuing sharp decline in the unemployment rate due primarily to the growth of aggregate demand. The lesson of this experience seems to be that the persistence of unemployment is due mainly to a deficiency of aggregate demand — a view which is shared by the Council of Economic Advisers and the majority opinion of the Clark Subcommittee on Employment and Manpower.

The Clark Subcommittee estimated in 1963 that reaching a target unemployment rate of 3 percent by 1968 would require an increase in federal expenditures of at least \$5 billion a year "in addition to the most favorable possible performance from the private sector of the economy." Further expansion of spending for the Viet Nam war could lift the economy closer to this target. But a mere continuation of present levels would most likely not be sufficient, and a cutback in spending could bring serious readjustment problems such as occurred after the Korean war — although nothing like the problems that would be created in the event of a disarmament program that wiped out a major part of federal defense expenditures. The main question for the future therefore is whether economic measures of sufficient magnitude will be utilized whenever needed. This reduces essentially to a question of whether the American economy can obtain and respond favorably to a large dose of government spending for nonmilitary purposes — which is the real test of the prognosis that is currently being advanced. Only events can give the answer.

Assurance Without Security

(Continued from page 2)

flation into an economy that was reacting from a temporary bulge of emotional overbuying.

The unavoidable uncertainty in the present situation makes flexible policy a necessity for the time being. The contingency to be avoided at all costs is an actual downturn activity. It is sound economic strategy to keep the Great Society programs alive and active. VLB