Massachusetts Ave., N.W.
Washington, D.C. 20036
November 18, 1968

Honorable Richard M. Nixon
Hotel Pierre
New York, New York

Dear Mr. Nixon:

The Task Force on the Budget submits the enclosed report, "Management of the Federal Budget."

We have not dealt with the problem of improving the process by which Congress acts on the budget. There is much to be done there. However, we believe the most important contribution the President can make to improving congressional procedures is to improve executive procedures. If the executive decisions are the result of systematic, objective appraisal of the effectiveness of alternative programs in satisfying explicitly stated objectives, the whole national mode of thinking about government spending will change and in time congressional behavior will conform to that. We do urge as one additional step the President can take that effective liaison be established between the Bureau of the Budget and the congressional leadership to promote better congressional understanding of the President's budget strategy and procedures.

We call attention to the inauguration in 1968 of a new "unified budget" concept, resulting from the work of the President's Commission on Budget Concepts. Although there are always questions that can be raised about any definition of the budget, this step has done much to eliminate confusion and suspicions that previously existed. We recommend strongly that the new Administration should embrace the new concept and press forward with the work now under way to implement it by adequate measurement of federal subsidies, establishment of government-wide accrual accounting, and integration of the unified budget with the national income accounts.

This report, together with our November 5 report on "Budget Policy for Early 1969," completes the present assignment of the Task Force. The members of the Task Force again wish to assure you of their desire to be helpful to your Administration as it takes up the difficult and important burden of managing the federal budget.

Sincerely yours,

Herbert Stein

Herbert Stein, Chairman
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Herbert Stein

December 3, 1968
Confidential

FISCAL POLICY FOR THE NEW ADMINISTRATION

The fiscal policy of the United States is now more uncertain and unsettled than at any time in the past forty years. During the past generation it seemed that the standard at which policy aimed - more or less imperfectly - was a compromise between budget balancing and use of the budget as an instrument of economic stabilization. Also, up to about 1966 movement was in the direction of greater weight to the economic stabilization, or "compensatory," part of the mixture. Certainly by 1965, if not much earlier, budget balancing had lost compelling force as a determinant of fiscal behavior. The budget-balancing rule was displaced by intellectual argument and even more by the observation that prolonged violation of the rule had no obvious ill effects. Around 1965, at the heyday of the "new economics," compensatory fiscal policy seemed to have established itself as the standard doctrine. But a few years of experience have greatly weakened confidence in this doctrine. The power of fiscal action to affect GNP, prices, and employment is much in doubt. Questions about our ability to direct that power in a stabilizing way are becoming more troublesome. The unwillingness of either the President or Congress to stick closely to the line of "compensatory" policy has become clear. Moreover, this unwillingness cannot be ascribed to mere ignorance, but is seen to reflect conflicting objectives that have some validity.

Thus, we are left without any standard and generally accepted guide to fiscal policy. This might seem to be an advantage since it permits the President to do what he wants without doctrinal limitations. However, that is not really the case. Neither the President nor anyone else can decide what he wants to do about fiscal policy unless he has some general view of what the main consequences of fiscal action are. Moreover, to carry out his fiscal policy the President will need the cooperation of the Congress, and it would be helpful to describe the fiscal policy as an application of some principles that the Congress recognizes to be sound and to bind the President as well as the Congress. In fact, the President cannot permanently keep fiscal policy at the level of ad hoc decision-making. Everything he does, and everything he says in justification of what he does, helps to influence public thinking about what fiscal policy should be and thereby builds up expectations which may limit or assist him in the future. For example, the words and deeds of the Kennedy-Johnson Administration over several years contributed to the demotion of the budget-balancing principle, a development which Johnson must surely have regretted when he came to fight for a tax increase. Also, exaggerated claims of the Administration on behalf of compensatory fiscal policy served later to weaken the effectiveness of arguments for fiscal action resting on that policy.

Therefore, it would seem necessary for the President to have some doctrine of fiscal policy as a basis for making his own decisions and influencing the decisions of others. One possibility might be to try to establish balancing the budget at high employment as the basic standard. This was the standard espoused in 1959 by the Cabinet Committee on Price Stability for Economic Growth, of which Richard Nixon was chairman. It has several advantages as compared with purer formulas of either budget-balancing or compensatory policy. However, whether any version of budget balancing can now command much support is doubtful. And even from the standpoint of the President this rule may be too inhibiting.

Probably there is no satisfactory alternative now to a discretionary fiscal policy, which would, however, differ from compensatory finance in giving weight to a number of other objectives in addition to economic stabilization. Policy would have to recognize and accommodate the following four considerations:

1. Despite growing skepticism about the effectiveness of fiscal action as an economic stabilizer, it is still not safe to assume that major changes in the relation between taxes and expenditures have no effect on economic activity, employment, and prices. A prudent course, from the standpoint of economic stabilization, would be to avoid radical shifts in the budget position unless there is strong evidence to suggest that such shifts would be in a stabilizing direction.

2. Although there are possible qualifications to this proposition, the size of the budget surplus or deficit affects the total saving in the economy - that total being higher when the surplus is larger. Therefore, a decision about the size of surplus or deficit

should reflect some decision about the desirable rate of saving. For example, if the government follows a policy of stimulating private investment, by tax incentives or otherwise, it may be appropriate to accompany this policy with a budget surplus to provide the saving out of which the investment can be financed.

3. The timing and dimension of federal expenditure decisions are mainly to be determined by the purposes to which they directly relate, rather than by their indirect effects on economic activity or total saving. We cannot decide to fight the Vietnam war when the economy needs stimulation and stop when it does not. This is an extreme example, but the point applies to most expenditures.

4. Tax decisions also have a life of their own and are not readily adapted, especially in the short run, to the overall requirements of fiscal policy. Frequent tax changes are at least a nuisance to taxpayers and may be a considerable impediment to efficient business management. Also, tax change packages, at least tax reduction packages, seem to have a necessary minimum size if the desirable structural consequences of change are to be achieved. Thus, the possibility of achieving tax reform is probably much smaller if five separate reductions of, say, $2 billion are made than if there is one reduction of $10 billion. The separate reductions are more likely to be totally absorbed in flat-rate reduction. Therefore, it may sometimes be appropriate to "save up" room for tax reduction rather than to make a series

of small reductions as soon as they are permitted by overall budget objectives. Moreover, tax changes tend to persist beyond the occasion that initially justified them and to evoke expenditure changes that may be undesirable. Thus, a tax increase is likely to result in expenditures subsequently being higher than they would otherwise have been, and this effect must be considered along with the immediate consequences of the tax increase.

The fiscal actions implied by each of these four considerations will usually be different. The surplus or deficit that is safest or most convenient for economic stabilization will often not be the one that would be chosen to yield the desired rate of total saving, and the specific objectives of expenditure and tax decisions will often conflict with achievement of the surplus or deficit that would be chosen on either stabilization or saving grounds. The severity of these conflicts can be reduced if monetary policy can be managed to make its maximum contribution to economic stability. It would also be reduced if it proved possible to manipulate some part of the tax structure flexibly and reversibly without serious consequences for business decision-making. Still, we must expect that all of the possible objectives of fiscal policy cannot be simultaneously achieved and that some imperfect compromise among them will be necessary. Moreover, the nature of the objectives and of our knowledge about them is such that the optimum compromise cannot be mechanically determined but can only be approximated by the exercise of judgment.

Despite these difficulties, the Administration in making its own decisions should be able to recognize more explicitly than heretofore the several considerations which must be balanced and should be able to explain its decisions more candidly and persuasively. It can avoid taking the unrealistic and unbelievable position that its fiscal recommendations are the "scientifically" determined outcome of devotion to a single objective, such as economic stability, or that they simultaneously and perfectly satisfy all objectives. There may seem to be a danger that exposing the Administration's recommendations as the outcome of judgment balancing a variety of objectives would weaken the Administration's leadership in fiscal matters in the country and in the Congress. However, the danger is greater the other way. The President starts with great advantages in the national debate about fiscal policy, because of the attention paid to everything he says, because of the unequalled amount of information he commands, and because of the breadth of the interests he represents. There is a natural tendency to accept his way of looking at things, and his recommendations, as sound, especially in a field where competing standards of soundness are weak. However, the President can himself dissipate this advantage if he allows major inconsistencies to appear between his avowed principles and his actual conduct.

One possible brief formulation of the kind of fiscal policy suggested here would be as follows: We shall try to avoid major shifts in the relation between revenues and expenditures at high employment while working gradually in the direction of a moderate surplus at high employment. However, we shall allow temporary departures from this program when precise adherence to it would require sacrifice of urgent expenditure objectives, unsettling tax variations, or tax commitments that would in the long run be undesirable.

A possible application of this policy to 1969 would be as follows: In the absence of an unexpectedly rapid decline of Vietnam spending, we shall retain the tax surcharge to the end of calendar 1969, in order to avoid a sharp jump in the deficit at mid-year. However, we do consider termination of the surcharge as important, in order to maintain the credibility of the government's decision to make a temporary tax increase and to continue pressure for restraint in spending. Therefore, we shall allow the surcharge to expire on December 31, 1969, by which time normal growth will have offset part of the revenue loss and the anti-inflationary effect of a restrictive monetary policy will be felt. We do not propose a crash effort to reduce expenditures but will work vigorously to initiate the reduction or restraint of the expenditures that are of low priority, with the expectation that this plus revenue growth will bring us to a position of budget surplus.