The Economic Club of New York

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# The Honorable Douglas Dillon

Secretary of the Treasury

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The fabulous success of the European Common Market presents this Nation with a challenge – an opportunity – and a promise:

A challenge, because the industrial might and know-how of the Common Market make it a formidable competitor in the trading centers of the world.

An opportunity, because the increasing demands of its thriving peoples are creating potentially vast new markets for American products.

A promise, because the prospering nations in the Common Market now have the capacity to assume a larger and more appropriate share of the cost of strengthening the defensive forces of freedom and of assisting less fortunate nations along the path to progress.

In responding to the challenge of the Common Market, we must realize that we live today in a highly-competitive, fast-changing new world, in which trade barriers are rapidly being lowered or eliminated. President Kennedy's new trade program recognizes that without mutual tariff reductions, we will be hobbled in our efforts to compete with foreign producers and will be unable to take advantage of the opportunities posed by the Common Market. But trade legislation alone will not keep us competitive. We must compete effectively. This calls for ingenuity and energy in developing new products and new markets, and it demands that the costs of American production be competitive.

These are not simple tasks. They will require concerted effort by every sector of our economy. For every sector of our economy is intimately involved. There is far more at stake than trade. The real stakes are the continued strength and well-being of this Nation and the survival of freedom itself.

In shaping our overall response to the challenge of the Common Market, we must keep constantly in mind these major national economic goals:

First, achieving the more rapid rate of economic growth that we must have to solve our persistent unemployment problem, as well as to remain competitive.

Second, maintaining reasonable price stability, which is essential if we are to increase our export sales, solve the imbalance in our international payments, and ensure the full enjoyment of their later years by senior citizens living on fixed retirement incomes.

Third, achieving and maintaining balance of payments equilibrium in a fashion that will permit us to carry our proper share of the free world's defense and furnish a fair proportion of the assistance needed by the newly-developing nations.

Growth is essential to our continuing prosperity because we must grow faster if we are to provide reasonably full employment for our swelling labor force. And only through rapid growth can

new technology be put to work fast enough to keep us competitive. Growth is also essential to long term equilibrium in our balance of payments. We cannot hope to solve our payments difficulties if our growth rate continues to drag along at little more than half that of our friends and competitors in Western Europe and Japan.

If we are to increase our growth from the rate of about three percent a year that characterized the Fifties, to the 4 ½ percent that has been set by the Organization for Economic Cooperation and Development as a fair and reasonable goal for its members in the Sixties, we must have an economic environment that will stimulate productive investment and business activity. Demand revenues that has been so effective during recent recessions. While there is understandable reluctance to grant such new authority, the concept of temporary tax reduction as an anti-recession measure appears to be generally accepted. Limited authority to the President under strict Congressional control would seem the best way of carrying out this concept.

The third element in the President's anti-recession program is limited standby authority to initiate or speed-up public works programs of the type that could be gotten underway rapidly, and substantially completed within twelve months.

These three new tools would greatly enhance our ability to deal with the economic slow-downs that have characterized our post-war economy. In so doing they should make possible a substantially more rapid rate of growth over the years ahead. Rapid growth in our free enterprise

system also requires a tax setting conducive to risk-taking – a setting that will give full play to individual initiative and effort – one that will genuinely stimulate investment. Such a tax structure calls for a basic revision of our income tax system, and that is exactly what the President has had in mind for the past year. At his direction, we in the Treasury have been working hard to develop such a new tax program. But taxes are complex. They affect every facet of our lives. They take time to develop, as well as to enact. The initial program submitted last year is still before the Congress. This has slowed our progress in developing the new program, but our work is progressing and we fully intend to submit proposals for overall reform of the income tax rate structure.

In the meantime, we are hopeful of rapid Congressional approval of the current tax bill, since its major element, the investment credit, is absolutely essential both to our growth and to our competitive position in the world.

During the past year, I have found general agreement that it is necessary to liberalize our treatment of depreciation so as to stimulate investment. A good deal can be done under present law, for our depreciation statutes are not as bad as they are often depicted. It is the administration of the law that has been primarily at fault. Revenue agents have been required to use as their guide for depreciation allowances, a bulletin put out by the Internal Revenue Service twenty years ago and never since modified. And, as if this obsolescence of the guidelines were not enough, it has also become clear that the basic concept in the guidelines of separate depreciable

lives for each and every tool and machine brings with it a great deal of unnecessary paperwork and argument. We intend to thoroughly revise and update these instructions. In our revision we will set forth broad classes of equipment to replace the 5,000 odd items presently listed in Bulletin F, as it is called.

Treasury studies, underway for nearly two years – and which for the first time take account of anticipated future obsolescence – indicate that we will also be able to substantially reduce the average guideline lives for depreciation. In the case of the textile industry, where the task has already been completed, the reductions averaged forty percent. However, since our manufacturers are already legally writing off their equipment at considerably faster rates than are provided in existing guidelines, the actual benefit of the revisions now underway will be considerably less than the projected percentage reductions in the guidelines. Present rates of depreciation are the result of agreements with revenue agents. These agreements have not been reached easily. They have involved a great deal of debate and compromise. Sometimes, they have required resort to the courts. Such unfortunate controversy has been the inevitable result of out-of-date guidelines which forced revenue agents to rely upon their own judgment in determining depreciable lives for the various pieces of equipment used by industry. One of our major aims in modernizing administrative depreciation practices is to reduce this area of contention and uncertainty to a minimum. We are confident that very significant progress is possible.

But all we can accomplish by the administrative route is not sufficient to meet the needs of American industry in today's competitive world. All of our competitors in Europe, Canada, and Japan go farther by providing some form of special incentive to modernize. Some of them use unrealistically short lives, which work in the same manner as the five-year amortization we have used in times of defense emergency. Others provide substantial special write-offs in the first year, usually called initial allowances. More recently, some of them have been turning to allowances over and above one hundred percent of depreciation – the same principle we are advocating in our investment credit. Such investment allowances are presently in effect in Belgium, the United Kingdom, and the Netherlands, and are now being adopted in Australia.

The resulting contrast with current practices here is dramatic. Taking the case of a piece of equipment, which has a fifteen-year life under our present laws, we find that manufacturers in Western Europe and Japan can write off an average of twenty-nine percent on similar equipment in the first year, compared to only 13.3 percent for American industrialists. Modernizing administrative practices can only close a small percentage of this gap. If American industry is to compete effectively, we must provide special incentives comparable to those available abroad. The only possible question can be over the way in which these incentives should be provided. The investment credit is one such way – and an extremely effective one. The combination of an eight percent investment credit and modernized administrative procedures will put American manufacturers on a comparable footing with their foreign competitors as far as investment in machinery and equipment is concerned.

The same result can, of course, be accomplished by various methods of accelerating depreciation beyond what is called for by realistic depreciable lives. But in the Treasury's view, the investment credit has two clearcut and important advantages over all methods of accelerated depreciation. The first is that the invest-allowance or credit, utilizing the principal of an allowance over and above 100 percent of original cost, increases the profitability of a given investment far more than any equivalent acceleration of depreciation. One of the most thorough studies on the subject, prepared for its membership in the machine tool industry by the Machinery and Allied Products Institute, finds that on a typical fifteen year asset, an eight percent investment credit has the same effect on profitability as a forty percent first year depreciation write-off. Let me repeat that. The eight percent investment credit which we are recommending has the same effect on profitability of investment as a special forty percent first year depreciation write-off. However, when we calculate the effect of these two methods on our tax revenues, we find that the first year revenue cost of the credit is $1.35 billion, while the cost of the forty percent initial allowance is $5.3 billion. Over a five-year period, assuming steady growth in the economy, the credit might cost something like $10 billion, compared to $24 billion for the comparable forty percent first year write-off. Similar results are reached when we compare the cost of other methods of accelerating depreciation to that of the credit.

I think you will all agree that government in these days should make every effort to get the most out of its dollars. Avoidance of waste is just as important in tax policy as it is in expenditure

policy. And that is one very good reason why we prefer the investment credit to the more expensive and less effective route of accelerated depreciation.

The second unique advantage of the credit is that it will not adversely affect costs or prices. Accelerated depreciation is often entered as an item of cost. This naturally inflates costs and shrinks profits, thus tending to promote the very price increases we must avoid.

I think you are all aware that the single largest increase in general manufacturing costs over the past few years has come from the increased depreciation write-offs permitted by the 1954 law which updated and liberalized depreciation procedures. This increase in costs was fully warranted, since it recognized the actual obsolescence rates of machinery. That is what depreciation is for and this will, of course, also be the effect of our administrative reforms. However, when it comes to an incentive, over and beyond realistic depreciation, the situation is quite different. As I have pointed out, the use of accelerated depreciation for this purpose would be wasteful of the government's tax dollar as compared to the credit, and would also tend to distort earnings and prices. For these two reasons, we stand firmly for the investment credit approach as the most feasible and practicable method of providing the stimulus to investment in machinery and equipment that we must have if we are to achieve the rate of growth required for a competitive and reasonably fully-employed economy.

Enactment of the investment credit also has an immediate importance. The greatest uncertainty

and the major soft spot in our current economic situation is the indication that business investment over the next year may be inadequate to sustain the pace of our recovery. Enactment of the credit will immediately generate new business in the machine tool and allied industries and will accelerate the incorporation of the latest technology into our productive system. It will shorten the lag-time between development and manufacture of new products, and thus help to open up new markets. It will stimulate industrial expansion and thus help to create the new jobs we so badly need. In short it will give a lift to our economy in exactly the place where it is most needed and at the very time it is most needed.

To the extent that investment is stimulated, new capital will be required. The national monetary and debt management policies that have been followed for the past year give assurance that the needed funds will be available at reasonable rates of interest. Today, with the recovery fourteen months old, the cost of new long-time corporate borrowing is lower than at any time since the economic advance got underway. At the same time, for balance of payments reasons, we have maintained and even moderately increased short-term interest rates, so as to equalize them with those obtainable abroad.

The investment credit, by promoting the use of modern, cost-cutting machinery, with help us to achieve our two other major economic goals: reasonable price stability and balance of payments equilibrium. Price stability is a must if we are to compete successfully in world market places, and it also makes for healthy economic and social conditions at home. Fortunately, conditions

today in the United States are favorable to price stability – if only we use restraint.
The strongest type of inflation is classical demand-inflation – too much money chasing too few goods. It is because of the danger of demand-inflation that we are wary of budget deficits. For Federal budget deficits create purchasing power. Whenever capacity is tight and demand is strong, deficits lead almost inevitably to a rise in prices which diminishes the value of all savings and helps no one but the lucky speculator.

However, and for at least the past four or five years, we have had no problem with demand-inflation. We have not known reasonably full employment since 1957. The slack in our economy was revealed by the fact that the record $12-1/2 billion deficit of fiscal year 1959 had no noticeable effect on wholesale prices. Neither has there been any effect from the $7 billion deficit we are running this fiscal year. As a matter of fact, wholesale prices are lower today than a year ago. I by no means wish to imply that we should not be concerned by deficits. But I do want to point out that the effect of a deficit on a slack economy is totally different from the effect of the same deficit on a full employment economy. We cannot afford deficits at full employment. Indeed, we anticipate substantial surpluses in such periods. With the prospect of rapid economic growth that led to last January's forecast of a gross national product of $570 billion for 1962, the President wisely presented a balanced budget. While the January and February slow-ups has made the achievement of this goal considerably more difficult, it is still possible. If we achieve it, there is no reason why we should not have a balanced budget as well. The main point to remember about our deficits is that they have been a reflection of the uneven pace of our

economy. Cure the recessions and the deficits will also disappear.

While we are on the subject of fiscal policy, I would like to digress for a moment to compare our experience with that of some of our European friends. There is a common misconception, both here and abroad, that our fiscal or budgetary performance is poor compared to such countries as France, the United Kingdom, and West Germany. That is simply not so. A recently completed study which converts the budgets of those countries to our accounting system, shows that our record is quite good. By adapting their data to our budget accounting methods Germany would show a budget deficit in every one of the past four years – the only years in which her post-war defense expenditures have been of any significance. France would show them in every one of the past ten years. And the United Kingdom would show deficits in nine of the past eleven years – and, in this connection, the Chancellor of the Exchequer has just forecast another deficit for the upcoming fiscal year. In contrast, the consolidated cash budget of the United States has been in deficit in only six out of the last eleven years.

Perhaps even more impressive is the fact that, over those same periods of time, the cumulative American deficit, as a percentage of gross national product, was the lowest. France's was the highest, with Germany next, and the United Kingdom third.

It is worthy of note that France and Germany, which run persistent deficits in their budgets, also run the greatest and most persistent surpluses in their balance of payments. That, of course, is not

because of their deficits, but rather because they have maintained competitive prices on their export goods – the key to payments surpluses – and have maintained them in the face of continuing full employment.

Despite the fortunate absence of demand-inflation from the American scene, we must continue to guard vigilantly against wage-price inflation, which can be just as dangerous and can strike at any time. If we are to avoid this type of inflation, prices should remain level or drop, and wage increases should be governed by increases in labor productivity. To help in defining these limits, the President's Council of Economic Advisors, in their annual report, set forth guidelines based on the performance of our economy, which has shown an average annual increase in productivity from 2 ½ to 3 ½ percent. As long as our economy continues to grow and productivity continues to increase at this rate, it should be possible to absorb wage increases of like magnitude without any increases in price. And remember that productivity also applies to capital. As the productivity of capital increases, there should also be room for increases in profits, to correspond with the increased wages of labor. All this will be possible if management and labor work jointly to make it possible – bearing the national interest in mind at all times.

Price stability is essential if we are to achieve our third major goal – balance of payments equilibrium. Without it, there can be no hope of achieving balance unless we invoke drastic actions that would do as much harm as good. That was the major reason for the President's great concern when, for a few days earlier this month, price stability appeared to be threatened.

Growth and price stability must both make their contribution to improving our payments problem by keeping our exports competitive. But still more is needed. For we have been forced to assume exceptional responsibilities in the defense of the free world. Those responsibilities put a great drain on our balance of payments – a drain which has recently averaged about $3 billion a year.

We must work to reduce this outflow by cutting out all non-essential costs and by obtaining offsetting payments from our European allies for U.S. military material and services.

A good start has been made. You have heard the President state that Secretary McNamara has accepted a goal of a billion-dollar reduction in the net outflow of defense dollars. About half of that goal has already been achieved through the recent agreement with West Germany, by which she is sharply increasing her purchases of U.S. military equipment. We are hopeful that similar arrangements can be made with other countries. The rest of the billion dollar goal will have to be achieved through economies in dollar expenditures. We are also using every opportunity to channel the maximum amount of our foreign aid funds into purchases in the United States, where they do not affect our balance of payments.

But there is another important area affecting our balance of payments where action is required if we are to achieve overall balance. I refer to the steadily increasing outflow of private investment

capital. The easiest way to handle this problem would be to utilize the standard European method – exchange controls. But we are firmly opposed to this approach, and so are pursuing two other avenues: We are working with our European friends in the OECD to liberalize their controls on capital movements, and we are urging them to develop their own internal capital markets so that they will not have to rely so heavily on our capital market. This is a slow process, but progress is being made. Our second method of slowing the capital outflow is by eliminating that portion of the outflow, perhaps as much as ten percent, that is induced by tax reasons. That is the basic aim of the Administration's foreign tax proposals. Those proposals are not directed against foreign investment as such. They merely attempt to put investment in the other industrialized countries on a par with investment here at home, as far as tax treatment is concerned. Their enactment would not only reduce the outflow of capital for direct investment in the other industrialized countries by some ten percent, it would also remove the artificial tax incentive to retain profits abroad and so would improve their return flow to the United States by roughly the same amount. The resulting overall balance of payments improvement should be something like $400 million a year. The great bulk of foreign investment – and I am confident it is not made for tax purposes – would continue as in the past. But that relatively small part that is purely tax-induced – and we all know that it does exist – would be eliminated, with substantial benefit to our balance of payments.

At the outset of my remarks, I said that the Common Market presents us with a challenge. But the greatest challenge lies within ourselves. We have the means at hand to solve our economic

problems – if only we will use them wisely and well. The most important is the stimulation of additional private investment in productive equipment. We must use that means to the full, and in a manner that will not jeopardize the national interest by short-sighted decisions – be they public or private.

If we do so, we can make significant progress toward achieving our goals of more rapid growth, price stability, fuller employment, and payments equilibrium. We can move boldly to take advantage of the competitive challenge of the Common Market, secure in the knowledge that our Nation is capable of seizing opportunities in foreign trade to help make a reality of America's vast promise of a fuller life for our own people and for free peoples everywhere.

End of Remarks