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How the Kennedy tax credit plan propelled an era of growth

by Andrew Rotstein

After eight years of partisan rhapsodies about the "longest peacetime expansion in American history," the United States is in an economic and financial gridlock.

Any observer unimpaired by ideology or narrow self-interest can see that as a productive nation, the U.S. is approaching third-rate status. The papier-mâché prosperity of recent years has left a staggering legacy of debt and other liabilities whose day of reckoning impends. In the current fiscal miasma in Washington, the agenda is defined by the need to avert insolvency and financial panic. The nation seems incapable—at least, under present conditions and policies—of any new great enterprises, like the Mars mission President Bush has endorsed.

In recent comments on the economic policy vacuum, *EIR* founder Lyndon LaRouche noted that the nation could well take a lead from the policies of the Kennedy era. In 1961, in tandem with the announcement of the manned Moon shot program, the new administration launched a campaign of industrial renewal, a campaign which benefited from the space project, but was also a vital condition for its success. The investment tax credit, one of the central components of the effort, provides a useful model for the present conjuncture.

The economy of the late 1950s was characterized by sluggish growth and repeated lapses into recession. Expansion was in the 2.5% range, inflation was high by peacetime standards, and problems like declining business investment, competition from a resurgent Europe, and the outflow of dollars, lurked in the background.

The legacy of stagnation was especially acute, and especially foreboding, in the industrial base. Business investment in fixed capital, which had been 12.5% of GNP in 1948, had fallen steadily, except for an uptick in 1956, and was below 10% for the decade's last three years. Producers' durable equipment, the key component of fixed capital, had dropped even more sharply, from 8.3% of GNP in 1948 to 5.6% in 1959-60—a fall of 33%.

Gearing to the 'promise of growth'

In April 1961, Kennedy called for the most significant revision of the federal tax code since 1954. The central feature of the bill was a novel proposal for an investment tax credit to spur capital spending by business.

The idea, according to Walter Heller, the chairman of the Council of Economic Advisers, was to shift the focus of government policy away from "corrective" action, geared to the swings of the business cycle, and toward a "propulsive orientation, geared to the dynamics and the promise of growth." Heller and his colleagues believed that expanded output, effected by measures that utilized idle capacity and created new capacity, provided a better guide to action than simply fine-tuning preexisting policies to avoid larger deficits.

This latter type of fiscal restraint had been the chief concern of the Eisenhower administration. Warnings about the scourge of excessive federal spending were candidate Nixon's stock answer to Kennedy's expansive 1960 campaign theme of "doing better" and "moving forward" as a nation.

In addition, there was a firm conviction that technological progress provided the indispensable basis for rising living standards and future growth, and that insufficient spurs to such advancement had bred the stagnation of the 1950s. American economic success, Kennedy noted in his tax message to Congress, "has been one of rising productivity, based on improvement in skills, advances in technology, and a growing supply of more efficient tools and equipment. This rise has been reflected in rising wages . . . as well as a healthy rate of growth for the economy as a whole."

How the incentive worked

When business firms buy new machinery or equipment, they are permitted to recover part of the cost of their investment by "writing it off" from their income for tax purposes over the designated "useful life" of the item.

The investment tax credit was a departure from the depreciation method. It was designed to create the maximum amount of new investment relative to the revenue loss to the Treasury, and to spur capital purchases that would not have been made without the investment tax credit. The idea was to allow a firm to take a proportion of its new investment as a credit, deducted directly from its taxes due. In fact, to encourage acceleration of investment, the original bill the administration submitted—later modified by Congress—would have

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created a sliding-scale system, giving enhanced rewards to firms with greater investment relative to past levels, as measured by their existing annual allowance for depreciation.

Specifically, a company that spent more on new plant and equipment than its depreciation allowance could deduct 15% of its investment above the allowed deduction; one that invested between 50 and 100% of its depreciation allowance could claim a credit of 6% on the amount above 50%. So, for example, a company with a depreciation allowance of $1 million that invested $2 million in one year in new factories, machinery, and vehicles, would be permitted to take 15% of the additional $1 million, or $150,000, off its taxes due. If the same company spent just $600,000 on fixed capital—that is, $100,000 more than 50% of its $1 million allowance—it would be allowed a credit of 6% of the difference, or only $6,000, from its tax obligation. There was also a straight 10% credit for smaller firms, and a universal 30% ceiling on the credit.

Encouraging investment, not speculation

The investment tax credit was estimated to result in a $1.7 billion revenue loss in the first year. To defuse political opposition from fiscal conservatives, the overall bill was revenue-neutral, calling for an equal amount in tax increases, mainly through closing of loopholes.

The package included other measures that clearly indicated a conscious attempt to create an economic environment geared toward technological renewal. For example, it actually called for *elimination* of existing incentives for investments in stocks, including a $50 exclusion and 4% credit for dividend income. In addition, the package made permanent a maximum corporate tax rate of 52%, which was scheduled to revert to 47% later that year. These moves suggest that the administration wanted to steer the benefit directly to new spending in productive capacity, and not simply to increase the income of corporations or private investors, to be used at their discretion for whatever purposes, productive or speculative.

Council of Economic Advisers member James Tobin, now at Yale University, confirmed to this author that such targeting was the intended strategy. During hearings at the time, then-Treasury Secretary Douglas Dillon, as lead-off witness to the House Ways and Means Committee, was similarly explicit: "The benefits from a cut in the corporate rate would be received by all companies, whether they invested or not. . . . I repeat that the purpose of the investment credit is not to provide general tax reduction for recipients of profit income. Rather, it is to stimulate investment in the most efficient manner."

The administration had good reason to doubt the efficacy of relying on corporate planners to reverse the Eisenhower stagnation. Major firms had been building up large stores of cash and other liquid assets, but had been skittish about the capital spending the country so desperately needed. One business journalist reported that Howard B. Speyer, the vice president and treasurer of Champion Spark Plug, looked at his company's balance sheet and was shocked to find cash and marketable securities worth $48.8 million—an incredible 48.6% of annual sales. "What are we running—a spark plug company or a bank?" he asked. A standing joke of the time was that General Motors, which was sitting on a $2.3 billion cash reserve, was "saving its money to buy the federal government."

A strategy for growth

Other concurrent policies further demonstrate that the investment tax credit was no isolated measure. For example, the White House attempted to deal with both industrial decay and the flight of dollars overseas by pressing the Federal Reserve to modify monetary policy in what the Council of Economic Advisers called the "monetary twist." Heller described this as the administration's effort "to twist the structure of interest rates so as to hold down the costs of long-term funds for investment in new plant and equipment while raising short-term rates to minimize the outflows of volatile funds to other countries. Successive increases in interest rates payable by commercial banks on time deposits played an important role in redirecting the flow of funds from the short to the longer term end of the spectrum and thus serving the objectives of the twist."

A year after introduction of the tax package, the Kennedy administration also backed legislation to speed up depreciation of assets by 10-20%, reinforcing the effect of the investment tax credit, and partly mollifying some business critics.

Heller is explicit that a high-technology vector to economic development was the indispensable basis for a period of robust growth without the raging inflation predicted by standard theory. "The harmonics of economic policy for cost-price stability . . . are a co-requisite of sustained prosperity. The discouraging pattern of recessions every two or three years between 1949 and 1960 has been broken," he later wrote, "not by a simple-minded devotion to demand stimulus [i.e., per Keynesian theory—ADR], but by a tight coupling of measures to boost demand with measures to boost productivity and hold costs in check—a combination designed to bring the demands of full employment into harmony with those of high growth, cost-price stability, and external payments equilibrium. Indeed," he concluded, "*sizable and sustained productivity advances may be thought of as 'the great reconciler'* " (emphasis added).

A 'most uncommon combination' of opponents

The tax package was announced in April 1961, and although initially eclipsed by the Bay of Pigs invasion, it stirred widespread controversy from the outset. Most reaction to the investment tax credit was decidedly negative. Business leaders considered the investment incentive gimmicky, inequitable, and hopelessly too complex to understand or ad-

minister. Most expressed their preference for more generous depreciation schedules instead. They also opposed other features of the larger plan, such as the elimination of the breaks on dividends, and the higher top corporate rate.

The bulk of the Democratic President's own party, including liberals and organized labor, was scarcely more hospitable. Most saw the approach as a "subsidy" or "giveaway" to business, which needed it least. The AFL-CIO and the Americans for Democratic Action both testified against it in Congress, calling instead for a tax break for lower- and middle-income Americans, to strengthen consumer demand.

According to a June 1961 *U.S. News and World Report* update, with the exception of a largely noncontroversial section affecting farm cooperatives, 114 non-government witnesses appeared before the Ways and Means Committee opposing features of the bill, a mere 17 in favor. On the investment tax credit itself, only two witnesses submitted favorable testimony, while 43 offered negative comments.

Most amusing, was the manner in which fixed ideological positions were not only offended, but outright confounded by a liberal Democratic President adopting a "pro-industry" tack. Ardent liberals considered the policy to be virtual heresy. Columnist Walter Lippmann and influential Democratic economist Leon Keyserling both likened the Kennedy administration to "a third Eisenhower term." Bruce Miroff, a leftist political scientist, later charged that measures like the investment tax credit exposed the hypocrisy of Kennedy's professed "progressive" ideals by "ensuring that the conservative, corporate definition of the American economy, now decked out in sophisticated Keynesian dress, remained ascendant."

Doctrinaire conservatives were equally outraged. Major business spokesmen, congenitally hostile to any affirmative federal role in the economy, said tax collection should serve the sole purpose of providing necessary revenue, and not give preference to any one type of behavior over another. Others, echoing their counterparts on the left, condemned the plan as a government subsidy, and thus contrary to free market nostrums. One critic called it nothing less than "socialistic."

Heller had a more sagacious, if less heated, view of the controversy. Far from the notion "that a major political party has moved from left to right, from a labor position to a business orientation, simply substituting a new dogma for an old," the tax program represented a different species of being altogether—an "escape from dogma," he called it.

The bill was stalemated in the First Session of the 87th Congress, but, after much compromise and more than a little armtwisting by Ways and Means Chairman Wilbur Mills, it eventually passed the House of Representatives in spring 1962. The sliding-scale provision had been eliminated, and a flat 8% credit put in its place.

But as it went to the Senate, the bill encountered what *New York Times* columnist Arthur Krock termed a "most uncommon combination" of liberals and conservatives of both parties in opposition, earning it "a special place in the history of revenue legislation." The coalition was led by Senate Finance Committee chairman Harry Byrd (D-Va.), the leading balanced-budget fundamentalist in the chamber. Among the other opponents were a leading tax liberal, Albert Gore, Sr., father of the current Tennessee senator; future presidential candidate Eugene McCarthy; and Connecticut's Prescott Bush, father of the current President.

The bill eventually passed with a 7% credit, and was signed by President Kennedy in October, taking effect retroactive to January 1962.

Slowly, surely, gaining converts

The investment tax credit was not initially welcomed by its intended beneficiaries. But, as the Council of Economic Advisers' Tobin and staff economist Robert Solow later wrote, "their appetite grew with the eating."

Congressional passage of the investment tax credit was covered by *Business Week* in an article entitled, "Business shrugs off new tax law." But a short six months later, the same magazine reported that a survey by McGraw-Hill's Department of Economics found that "businessmen have revised their capital spending plans sharply upward. The $40 billion they now plan to sink into new plant and equipment this year will set an all-time record."

"The slow growth of the U.S. economy during the past five years," it notes, "traces more to a lack of dynamism in capital spending than to anything else. So the promise of a speedup in the growth of capital spending is also the hope of a faster long-term growth rate for the economy as a whole."

McGraw-Hill specifically found that "despite early skepticism, [companies] added some $1.2 billion to their 1963 spending plans to take advantage" of the bill's programs. It also found that even preliminary long-term plans projected a steady acceleration through 1966. Significantly, the survey inquired for the first time whether projected investment was based on current orders or expectation of future growth. Demonstrating the momentum generated by the tax package, the article notes that "answers to the questions clearly indicate that it is the long-term growth that companies now have in mind."

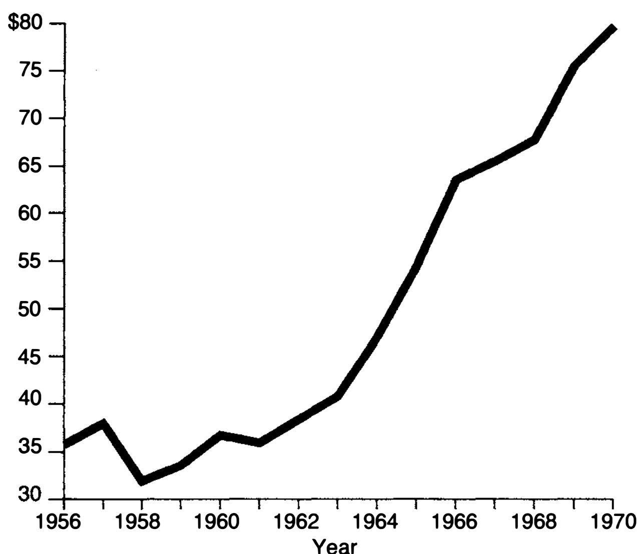
Apparent converts themselves, *Business Week* editorially noted, "Skeptics about the contribution that government tax policies can make to economic growth should take a careful look at the new survey's findings on why business is boosting its capital spending figures."

Overall, fixed non-residential investment, which grew an anemic 11.4% for the entire 1957-62 period, surged 61.9% for the comparable five-year period which followed (see **Figure 1**).

The economy begins to take off

The effect of the investment initiative naturally cannot be judged in isolation from other elements of policy or from

FIGURE 1
Investment in new plant and equipment spurred by Kennedy tax credit
(billion $)



Source: *Historical Statistics of the United States.*

larger economic conditions. The Kennedy administration accelerated the federal commitment to public works, a vital determinant of growth and productivity. It continued the intensive, remedial efforts of the Eisenhower administration, in response to the shock of the Soviet Sputnik launch of 1957, to upgrade science, mathematics, and language education through the National Defense Education Act. Most of all, Kennedy mobilized the material, scientific, and civic resources of the nation behind a vastly upgraded space program, when he announced in May 1961 that Project Apollo would land Americans on the Moon before the end of the decade.

In the period of the most intensive work on the program to land a man on the Moon, from 1961 to 1965, and even until the substantial winding down of the NASA budget in the early 1970s, an unprecedented series of technological innovations was fed into the economy as a whole. Conjoining the benefits of the investment tax credit, and other measures of the 1962 and 1964 tax bills, to the technological gains associated with the NASA, provided a massive boost to the economy.

Even a cursory examination of some basic indicators powerfully suggests the trend. Over the three years of the Kennedy administration, the Gross National Product increased some 20%, or $100 billion a year, for an average annual growth rate of 5.5% measured in constant dollars—over twice the rate of the 1950s. Wholesale prices were virtually unchanged, and the cost of living rose only slightly over 1% per year.

By comparison, generally prosperous economies of Western Europe were experiencing inflation two to three times that rate. From March 1961 to March 1964, the ratio of GNP increase to price increases was 4:1, compared to 3:2 in the 1952-60 period. Indicating the validity of Heller's dictum about investment as the real counter to inflation, between 1961 and 1965, unit labor costs increased an average of 0.6% per year, compared to 2.1% from 1953-57, and 1.4% from 1957-60. Unit labor costs in manufacturing during the same period actually fell, as the average 3.6% annual increase in hourly compensation was outstripped by 4% yearly growth in output per manhour. Over the period of 1961-66, real per capita income rose by 20%, corporate profits doubled, and 7 million new jobs were created. Although unemployment was naggingly persistent, it abated to 4% by mid-decade.

The Reagan program in comparison

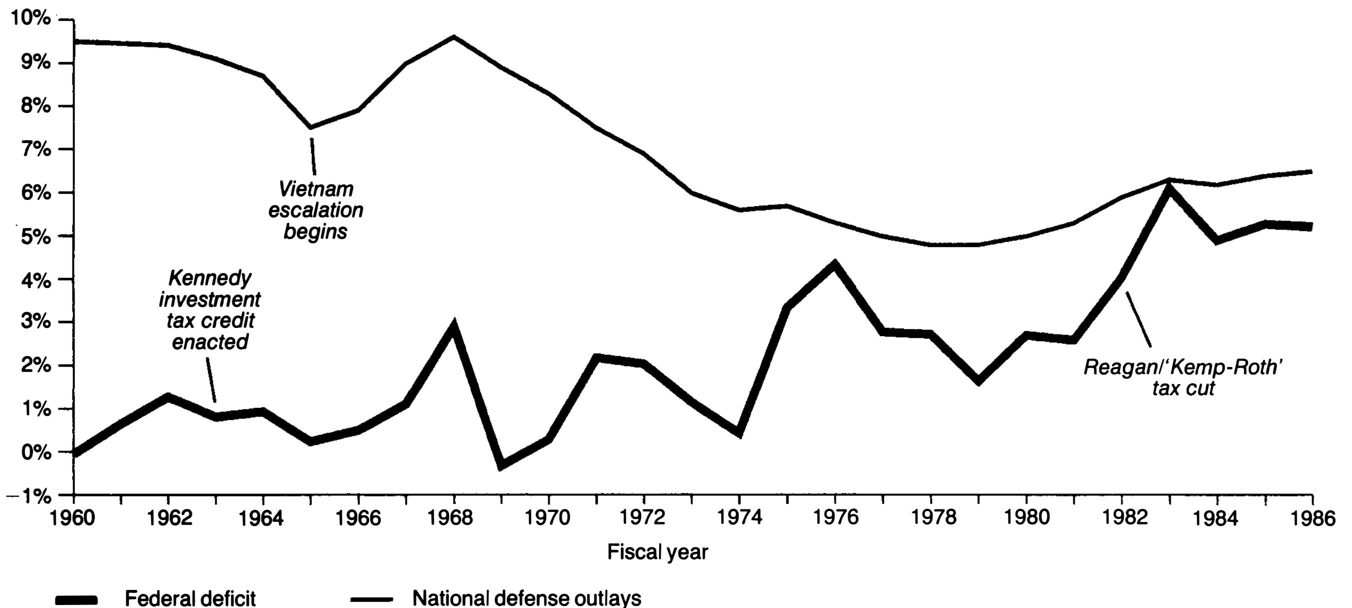
In attempting to drive an economic recovery with a tax cut and incentives for capital formation, the Kennedy policies obviously invite comparison with those of the first Reagan term. On one level, a limited parallel is justified. Some Reagan advocates pointed out that a low-growth economy, with substantial amounts of unutilized or low-productivity capacity, creates an economic and fiscal drag. They stressed the futility of attempting to redistribute wealth in the absence of increasing employment and output. In this, they share a useful insight with the Kennedy advisers.

But the Reagan administration's remedies never matched their public billing. With a few exceptions, like the provision for accelerated depreciation in the 1981 tax cut, the Reagan policy was blind to the distinction between investment in physical assets for useful production, and those plowed into wildly speculative chain-letter schemes. In contrast to John F. Kennedy's policy, the Reagan White House was ideologically adverse to attempts to target benefits to productivity-boosting investment.

As a result, it wound up largely providing a boon for speculation.

Both tax cuts were followed by periods of growing federal expenditures and revenues. But the Kennedy program set off broad industrial progress, in which federal deficits were modest in comparison to GNP (see **Figure 2**). The Reagan cuts spawned growing deficits relative to GNP which would appear even larger if the nonproductive component of GNP were discounted. More importantly, the speculative expansion of the 1980s was heavily debt-financed, sowing the seeds of its own collapse in the asset deflation now picking up momentum in the real estate and banking sectors. A useful contrast is the trend of national public debt relative to the economy as a whole: From 1961 to 1970, it decreased from 56 to 39%; from 1981 to 1990, it is a reverse curve, growing from 34% to over 55%.

FIGURE 2
Kennedy tax cut helped revenue base, while Reagan's caused deficit to zoom
(normalized as percent of Gross National Product)



Source: *Statistical Abstract of the United States.*

Even using the deeply flawed accounting methods of the U.S. government—which count all forms of national income, whether useful or speculative, as equivalent—the different trajectories of the economy in response to the tax cuts of 1963-64 and of 1981 (taking effect in following fiscal years) are apparent.

The familiar argument that U.S. fiscal and economic health were simply undercut by an unbearable level of defense spending in the 1980s is contradicted by the fact that, even during the vaunted Reagan "build-up" of 1981-85, defense spending never attained the relative levels of the Kennedy era.

As noted, these figures do not discount the non-productive component of GNP. Since this sector has mushroomed in the 1970s and '80s, a more accurate accounting would show an even more pronounced rise in the relative burden of public debt in the 1980s.

The graph terminates in 1986, since the Gramm-Rudman bill of 1985 altered on-budget and off-budget guidelines, making more recent comparisons meaningless.

Of course, this is not a simple, single, cause-and-effect reaction to tax measures. By 1981, years of misguided "post-industrial" policies, capped by the bloodletting of Federal Reserve chairman Paul Volcker's regime of usury, had substantially hollowed out the United States as a productive economy. The difference, rather, signifies that between a technologically progressing industrial nation, and one living on borrowed time and money, limping along on the basis of swapping back and forth securities and all manner of derivative paper.

Emblematic of the times, the tax bill of 1986—supported alike by the Reagan administration and by the Democratic leadership of Congress—finally abolished the remnants of the investment tax credit.

The investment credit was not the only component of Kennedy's economic agenda, or necessarily the dominant one. But it was a sound and imaginative innovation which, when meshed with the scientific cornucopia of the space program in its heyday, yielded stunning results.

Hand of the law-giver

These achievements stand as an example of what is possible when the economic affairs of the nation are reasonably well ordered. Despite years of disinvestment, despite unremitting waves of malthusian, zero-growth propaganda, there remains a strong impulse for economic growth among most citizens. In the political ferment ahead, these achievements of the recent past could teach Americans that, as economist Lionel Robins has written, what makes men act for the common good, even though that was not their original intention, is not the "invisible hand" of Adam Smith, but the benevolent hand of the enlightened law-giver.