

467 467
**ECONOMIC ANALYSIS AND THE
EFFICIENCY OF GOVERNMENT**

HEARINGS
BEFORE THE
SUBCOMMITTEE ON ECONOMY IN GOVERNMENT
OF THE
JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES
NINETY-FIRST CONGRESS
FIRST SESSION

PART 1

AUGUST 12; SEPTEMBER 16 AND 19, 1969

Printed for the use of the Joint Economic Committee

LIBRARY COPY
(PLEASE RETURN)
JOINT ECONOMIC CTTE.
G 133 NEW SENATE OFF. BLDG.



U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1970

36-125 O

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price \$1.00

734

JOINT ECONOMIC COMMITTEE

[Created pursuant to sec. 5(a) of Public Law 304, 79th Cong]

WRIGHT PATMAN, Texas, *Chairman*
WILLIAM PROXMIRE, Wisconsin, *Vice Chairman*

HOUSE OF REPRESENTATIVES

RICHARD BOLLING, Missouri
HALE BOGGS, Louisiana
HENRY S. REUSS, Wisconsin
MARTHA W. GRIFFITHS, Michigan
WILLIAM S. MOORHEAD, Pennsylvania
WILLIAM B. WIDNALL, New Jersey
W. E. BROCK 3d, Tennessee
BARBER B. CONABLE, Jr., New York
CLARENCE J. BROWN, Ohio

SENATE

JOHN SPARKMAN, Alabama
J. W. FULBRIGHT, Arkansas
HERMAN E. TALMADGE, Georgia
STUART SYMINGTON, Missouri
ABRAHAM RIBICOFF, Connecticut
JACOB K. JAVITS, New York
JACK MILLER, Iowa
LEN B. JORDAN, Idaho
CHARLES H. PERCY, Illinois

JOHN R. STARK, *Executive Director*
JAMES W. KNOWLES, *Director of Research*

ECONOMISTS

ROBERT H. HAVEMAN **JOHN R. KARLIK** **RICHARD F. KAUFMAN**
FRAZIER KELLOGG **LOUGHLIN F. MCHUGH**
Minority: DOUGLAS C. FRECHTLING **GEORGE D. KRUMBHAAR**

SUBCOMMITTEE ON ECONOMY IN GOVERNMENT

WILLIAM PROXMIRE, Wisconsin, *Chairman*

SENATE

JOHN SPARKMAN, Alabama
STUART SYMINGTON, Missouri
LEN B. JORDAN, Idaho
CHARLES H. PERCY, Illinois

HOUSE OF REPRESENTATIVES

WRIGHT PATMAN, Texas
MARTHA W. GRIFFITHS, Michigan
WILLIAM S. MOORHEAD, Pennsylvania
BARBER B. CONABLE, Jr., New York
CLARENCE J. BROWN, Ohio

CONTENTS

WITNESSES AND STATEMENTS

TUESDAY, AUGUST 12, 1969

	Page
Proxmire, Hon. William, chairman of the Subcommittee on Economy in Government: Opening remarks.....	1
Anthony, Robert N., Ross Graham Walker professor of management control, Harvard Business School.....	3
Nielsen, Thomas H., U.S. Financial Corp.....	6

TUESDAY, SEPTEMBER 16, 1969

Johnson, Nicholas, Commissioner, Federal Communications Commission....	58
Surrey, Stanley, Harvard Law School.....	82

FRIDAY, SEPTEMBER 19, 1969

Zwick, Charles J., president, Southeast Bancorporation, Miami, Fla.....	163
White, Lee C., a partner in the law firm of Semer, White & Jacobsen....	186

SUBMISSIONS

Anthony, Robert N.:	
Response to chairman Proxmire's query relative to Mr. Moot's accomplishments in the area of better control systems in the performance measurement area.....	43
List of actions adding up to \$3 billion by Project 683 in an effort to reduce expenditures in fiscal year 1968.....	51
Conable, Hon. Barber B., Jr.:	
Letters sent out to former Defense Department officials inviting them to appear and their respective responses.....	13
Article: "Defense Profits: The Hidden Issues," by Allan T. Demaree, reprinted from Fortune magazine, August, 1 1969.....	15
Johnson, Nicholas:	
Response to additional questions of Chairman Proxmire.....	78
Proxmire, Hon. William:	
CODSIA statement on cost/schedule control systems criteria and the letter accompanying it to Assistant Secretary of Defense Barry Shillito from a number of persons responsible.....	35
A bill to amend the Communications Act of 1934 to establish orderly procedures for the consideration of applications for renewal of broadcast licenses (S. 2004, 91st Cong., first sess.).....	71
Surrey, Stanley:	
Documents supplementing testimony:	
Excerpt from fiscal 1968 Report of the Secretary of the Treasury.....	92
Excerpt from statement of Secretary of the Treasury Barr before the Joint Economic Committee hearings on the 1969 Economic Report of the President, January 17, 1969, part 1, Pages 11-44.....	111
White, Lee C.:	
Prepared statement.....	190
Response to Chairman Proxmire's query relative to a detailed statement of user charges the FPC has received in recent years, together with a summary of proposals that have been under consideration....	202
Zwick, Charles J.:	
Prepared statement.....	168

ECONOMIC ANALYSIS AND THE EFFICIENCY OF GOVERNMENT

TUESDAY, AUGUST 12, 1969

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON ECONOMY IN GOVERNMENT
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Subcommittee on Economy in Government met, pursuant to notice, at 10 a.m., in room 318, Old Senate Office Building, Hon. William Proxmire (chairman of the subcommittee) presiding.

Present: Senator Proxmire and Representative Conable.

Also present: John R. Stark, executive director, and Loughlin F. McHugh, economist.

Chairman PROXMIRE. The subcommittee will come to order.

Today's session marks the opening of a series of hearings by the Subcommittee on Economy in Government on "Economic Analysis and the Efficiency of Government." These hearings represents a logical continuation of the longrun efforts of this subcommittee to pinpoint areas of waste and inefficiency in Federal Government policy and to focus attention on the potential contributions of improved budgetary procedures and policy analysis in attaining efficiency in Government.

In recent hearings before this subcommittee on the application of planning-programing-budgeting techniques, we have learned of enormous resource misallocation resulting from a decisionmaking process which neglected to carefully consider the benefits and costs of decisions. In our military budget hearings,¹ we encountered major instances of waste because of program mismanagement and an attitude problem in which cost control and cost consciousness were viewed by program managers as a form of disease. We have learned that many instances of misguided policy are due to the failure of Federal Government decisionmakers to build into programs incentives for desirable behavior or to pay sufficient attention to the relationship of costs to performance. Because of these instances of inefficiency, vast amounts of national resources are being misallocated and huge subsidies are granted to private interest groups.

In this set of hearings, we will undertake a comprehensive look at the efficiency of Federal economic policy. We will hear a number of case studies describing Federal policy which has encouraged waste and resource misallocation and through these case studies, we will put the spotlight on those problem areas requiring the attention of both

¹ The Military Budget and National Economic Priorities hearings, Subcommittee on Economy in Government of the Joint Economic Committee, U.S. Congress. June 1969.

the executive branch and the Congress. The areas which will be surveyed will include both spending and regulatory policy. We will inquire into the resource allocation effects of maritime subsidies, Federal airports and airline policy, water resource and pollution control expenditures, and programs in urban development and medical care.

Because both tax expenditures and rulemaking activities have substantial influence on the allocation of the Nation's resources, we will also hear testimony on these matters.

It is hoped that, because of these hearings, public attention will be focused on those sectors of public policy which require increased scrutiny and evaluation by both executive decisionmakers and the Congress. Improved policy will result only if far greater attention is paid to the costs and benefits of alternative means of attaining social objectives. Through the public airing of clear cases of Federal policy which fosters waste and resource misallocation, improved policy based on careful analysis and planning can be attained.

It should be emphasized that, in this period of budget stringency caused by Vietnam expenditures, efforts to ferret out and eliminate wasteful public expenditures is of the utmost importance. The Congress is missing a golden opportunity if it fails to use the current concern for expenditure reduction to eliminate wasteful and inefficient programs. It is in times like these that economic analysis focusing on benefits and costs can be of great service in improving the efficiency and responsiveness of Government. The growing taxpayers' revolt is based upon public distaste for the inefficient programs to which tax money is being devoted, the huge subsidies granted to many whose claim for subsidy is not particularly meritorious, and the lack of meaningful national priorities to guide budget allocation.

In this morning's session, we will hear the testimony of two former officials in the Defense Department. Both of these witnesses have had long experience in the development and management of Defense Department programs. Both will be able to suggest a number of ways of improving the efficiency of procurement and expenditure policy in that agency. At the conclusion of this subcommittee's hearings on the military budget and national economic priorities, a number of members of this subcommittee—one of whom is Congressman Conable, a very able member, who is here this morning—felt that we should hear from Defense Department officials of prior administrations. In a sense, then, this hearing represents unfinished business of the military budget and national economic priorities hearings.² On the other hand, based on the evidence in those hearings, there is no better way to initiate a study of resource misallocation and inefficiency in Government than to focus on problems of management and control in the Defense Department.

We welcome today Dr. Robert Anthony, Ross Graham Walker Professor of Management Control of the Harvard Business School, and Thomas H. Nielsen of U.S. Financial Corp. Dr. Anthony is former Assistant Secretary of Defense, Comptroller. Mr. Nielsen is former Assistant Secretary of the Air Force for Financial Management.

² "The Military Budget and National Economic Priorities," hearings, Subcommittee on Economy in Government, Joint Economic Committee, U.S. Congress, June 1969.

I want to say that Dr. Anthony received his A.B. degree from Colby College and his masters and Ph. D. degree from Harvard University. He has been on the faculty of the Harvard Business School since 1940, with intermittent periods of Government service.

I think, Dr. Anthony, you were a classmate of mine at Harvard Business School. We both graduated in 1940.

He is a member of several professional accounting associations and is the author of a number of important works dealing with management control and accounting, principles of financial management, and planning control systems.

Mr. Nielsen graduated from the University of Washington and the Graduate School of Business at Stanford University. As he notes in his statement, he has served with various companies as treasurer, comptroller, and business manager. In 1965, he became the president of California Land Co., where he directed the building of a new community in southern California.

Dr. Anthony, you may begin.

**STATEMENT OF ROBERT N. ANTHONY, ROSS GRAHAM WALKER
PROFESSOR OF MANAGEMENT CONTROL, HARVARD BUSINESS
SCHOOL**

MR. ANTHONY. Mr. Chairman and members of the subcommittee, the committee has performed a significant public service in bringing to light instances that indicate weakness in the present management process in the Department of Defense. I assume that your basic interest is not in these incidents in and of themselves, but rather in ways of improving the process so as to reduce their recurrence—I say “reduce” rather than “prevent” because it would be unrealistic to suppose that waste and inefficiency can be entirely prevented in any organization, let alone in Defense which is one of the largest and most complicated organizations in the world.

Discussion of all the topics listed in your invitation would obviously take much more time than is available. I shall, therefore, limit this statement to a brief summary of some suggestions in two areas: (1) management of internal operations and, (2) the acquisition of major weapons systems.

INTERNAL MANAGEMENT

Over the past several years, significant improvements have been made in the planning and control process. The Honorable Robert C. Moot, my successor as Assistant Secretary of Defense, Comptroller, described these new techniques in his statement of June 6 to the subcommittee.

The subcommittee has heard criticisms of the techniques that are variously labeled “systems analysis” and “cost-benefit analysis.” Although there, of course, can be differences of judgment on the analysis of a specific problem, the techniques have generally led to better decisions, particularly decisions relating to the procurement of proposed new weapons systems, and such decisions are of great importance in the task of promoting economy. Improved procurement practices can perhaps save several cents on the dollar, whereas a decision against

procuring an unneeded weapons system at all saves 100 cents on the dollar.

The critics tend to be self-serving. If the analysts demonstrate that nuclear-powered carrier escorts are not a worthwhile investment, then the proponents of nuclear-powered carriers escorts are naturally unhappy, and one way of expressing this unhappiness is to depreciate the world of the systems analysts.

It is, of course, easy to find specific instances in which the analysts made questionable recommendations; they are human beings dealing with extremely complex problems, and human beings are not perfect. But by and large, I believe that the introduction of these new analytical techniques is one of the most significant innovations in recent years.

A second recent development is the new systems for measuring the operating costs of Defense installations and activities, called Project PRIME. A manager can't control costs unless he knows what the costs are, yet until last year less than half the direct costs of operating a typical Defense installation showed up in the accounting records. Project PRIME, when it is fully implemented, will collect substantially all the operating costs, and this information will be a powerful tool to managers at all levels.

Installation of the new system began on July 1, 1968, and reliable costs are just now starting to be reported. It will be another year before good comparative data are available, and several more years before all aspects of the system are implemented and managers learn how to get the greatest benefit from it. Your support of this effort, particularly during the current transition period, would be most helpful.

WEAPONS SYSTEMS ACQUISITIONS

In the acquisitions area, I shall limit myself to eight comments, one negative and seven positive.

To take the negative one first, I record my doubts about the practicality of increasing the proportion of fixed-price contracts. The cost of a new house, a new office building, or a new automobile model can be closely estimated in advance because the new article is similar to articles that have been produced before and whose cost is known. By contrast, most new weapons systems differ in significant respects from anything that has been produced before, and it is accordingly impossible to estimate accurately their cost in advance. Unless both the Government and the contractor are confident of the accuracy of cost estimates, there is no reasonable basis for a fixed-price contract. Thus, it seems to me that relatively few contracts for major new weapons systems can be of the fixed-price type, and that the major direction for improving the contracting process is in improving the techniques of cost-type contracting.

Some improvements that I think should be pursued are as follows:

1. *Recognition of capital employed.*—In most contracts, profit is calculated as essentially a percentage of estimated cost. Thus, if costs are estimated to be \$10 million, the allowed profit is likely to be about 10 percent of \$10 million, or \$1 million. Little or no recognition is given to the capital employed by the contractor; that is, the profit is likely to be \$1 million whether the contractor uses \$2 million of his

own capital or whether he uses \$5 million, although in the former case he makes 50 percent return on his investment and in the latter case he makes 20 percent. Since return on investment is the best single measure of corporate performance, there is little economic justification for these differences in return. The practice of figuring profit as a percentage of cost is the principal reason for the high rates of return on certain specific contracts that have been cited to your subcommittee.

People used to argue that a system for basing at least part of the profit on capital employed would be too complicated to be practical. Within the last few years, however, practical methods of doing this have been worked out and thoroughly tested. In my opinion, this approach to calculating profit should be adopted immediately. Not only is it more equitable, but it would also tend to mitigate certain uneconomic practices that are encouraged by the present method, primarily the tendency to lease assets that should be purchased, to use Government-owned assets rather than corporate-owned assets, and to pay inadequate attention to inventory levels.

2. *Overhead contracts.*—The allowance for overhead costs on a contract is customarily figured as a percentage of direct costs. It would be preferable, in my opinion, to negotiate a separate contract for the overhead costs of a contractor, or division of a contractor, that works exclusively or primarily on Government work. Such a contract would lessen the present tendency to increase direct costs in order to earn an additional allowance via the overhead rate. More importantly, it would tend to focus attention on the dollar amount of overhead costs, which is obscured by the use of overhead rates. The contract could, where appropriate, specify a fixed dollar amount per month plus a variable portion to reflect variations in overhead cost, if any, that are a function of the level of activity.

In order to carry out this suggestion, it would be necessary to draw a sharp line between overhead costs and direct costs; otherwise costs would tend to migrate from one category to the other. This poses a substantial problem, but not an insurmountable one.

3. *Prospective overhead contracts.*—In some contracts, the overhead rate is not calculated until after the event. Under these circumstances, the contractor has no motivation to control overhead costs since he is guaranteed reimbursement for whatever he spends, except in these cases where the auditor discovers a specific item of cost that is unallowable. The amount to be paid for overhead, whether in the form of a rate or in the form of a specific overhead contract, should ordinarily be set in advance of contract performance.

4. *Better overhead analysis.*—Although I cannot support this with adequate data, it is my impression that overhead costs of some contracts are higher than they need to be. The Government does not have good tools for analyzing the proper level of overhead costs. In particular, it lacks good information on the average costs of performing certain overhead functions—for example, personnel, accounting, production control—in American companies. Although there are many problems involved in collecting comparable costs of these functions, they are not insurmountable problems, and I think it would be worthwhile to make a vigorous effort to solve them.

5. *Cost standards.*—The Congress has already instructed the Comptroller General to investigate the feasibility of writing uniform cost standards. I think this is an area of great promise.

6. *Contract changes.* Current procedures are inadequate for insuring that the additional costs allowed in connection with contract changes are only the costs associated with the approved change, and no more. They should be tightened. Also, it would be interesting to investigate the feasibility of permitting no profit allowance on such changes, unless the change is the consequence of a demonstrable increase in performance specifications, for this would impose a strong penalty on underpricing; that is, on buying in. I am not yet convinced that this is practicable, however.

7. *Performance measurement.*—Although much improved in recent years, the techniques used to measure and control contractor performance are still inadequate. They require mountains of paperwork, but nevertheless they do not produce the information that is needed for effective surveillance of the contract. In essence, the requirements of a good control system are that it should compare actual work accomplished, actual time taken, and actual cost incurred, with the planned amounts in each of these dimensions. The foundations for such a system have been laid, and Mr. Moot and his organization are vigorously at work seeing to it that better control systems are installed. This effort should be encouraged.

No system, by itself, produces control. Control is exercised through human beings. An effort of considerable magnitude is warranted to educate personnel involved in the procurement process in how to use the new information when it becomes available. Also, the staffs available to analyze this information in the Office of the Secretary of Defense and the offices of the secretaries of the military departments are, in my judgment, too small. A modest increase would pay big dividends.

CONCLUSION

None of the suggestions I have made above is new. My hope is that they will be useful to the subcommittee in reaching conclusions as to which of the many suggestions that have been made are worth supporting. Improvement in the procurement process is more likely to occur through the vigorous implementation of ideas being worked on than through such radical changes as the elimination of cost-type contracts, which I regard as completely unrealistic, or a Government takeover of major defense contractors, which I regard as completely naive.

Chairman PROXMIRE. Thank you, Dr. Anthony.
Mr. Nielsen?

STATEMENT OF THOMAS H. NIELSEN, U.S. FINANCIAL CORP.

Mr. NIELSEN. Mr. Chairman and members of the subcommittee, when I was first asked to appear before this committee, I responded that I would be in Washington only briefly while I picked up my family, who are here with me today, and we began our move to California. Fortunately, your hearings today have occurred during this visit to Washington, and so I appear before you in an attempt to con-

tribute to these hearings by offering my observations on the subject of your inquiry, based on a short but exhilarating and frustrating experience as Assistant Secretary of the Air Force for Financial Management.

My purpose in describing my background, which you have summarized, Mr. Chairman, is to illustrate that, prior to becoming Assistant Secretary in January of 1968, my experience and exposure to the complex problems, which are of primary interest to you, consisted of my prior Navy experience as an ensign in the Navy, an introduction to business and government while attending Stanford University and, what I suppose was an average citizen's interest in the affairs of Washington for the past 10 years.

I like to think, then, that I started 2 years ago without too many preconceived ideas about the military-industrial complex and the men and women implementing our public programs.

Now, however, after a brief 1½ years, I have some very definite thoughts concerning this Government and the people who manage its affairs. Today, I would like to discuss two areas which I believe may be of most interest to this subcommittee.

The first area concerns the incredibly difficult and complex task which the Members of the Congress undertake annually to determine the programs this country intends to pursue—the problem of choosing tomorrow's programs.

This second area concerns our ability to implement and execute the chosen programs efficiently and effectively.

First, let me discuss the problem of choosing tomorrow's programs.

I cannot honestly tell you, after 1½ years of working on budgets and programs for the Air Force, whether the amount of national resources devoted to national defense is too high, too low, or just right. I can assert, however, that, in my judgment, for the past 8 years, the Defense Department has at least been asking the right question. That is: How much is needed for one program more than it is needed for another program? In addition, this question is being asked within the context of a meaningful 5-year program. Now, with the new administration, these questions of program level may be asked within the context of some kind of economic constraint.

I heartily approve and strongly recommend this new step. If it is implemented by the Department of Defense, additional light may be shed on the risks associated with varying the level of resources allocated to defense needs. In addition, I would hope that the Joint Chiefs of Staff could become a more effective part of this resource allocation process; for, although the Joint Chiefs in the past have submitted a joint strategic objectives plan to the Secretary of Defense to begin the planning and programing cycle, this list of requirements has never been subjected to any kind of economic guidance or constraint.

When I left office, in June, the programing system was moving in the direction I have mentioned, and, as I have stated, I strongly support this kind of change.

But what of this planning and programing system beyond the Department of Defense? Isn't it possible to establish a 5-year program for the Government as a whole? Shouldn't you, the program deciders, the Congress, receive such a plan with the annual budget message? Is it realistic to confine your approvals to an annual budget?

In my judgment, it is not.

A 5-year plan for the Government as a whole should be prepared and submitted for the Congress annually. This plan should be prepared on a program basis just as the 5-year defense plan of the Department of Defense. It should include, as an example, within the housing program all efforts underway to solve our housing programs; HUD's Operation Breakthrough; DOD's research housing, and many others.

At the present time, the overall Federal budget serves:

First; as an instrument for aggregating and displaying annually the expenditure proposals of the executive branch as a basis for appropriation decisions by the Congress; and

Second; as a *control* medium through which spending decisions are administratively implemented and financial accountability assured.

As long as the decision structure can be readily translated into an implementation structure by way of an appropriate crossover network, there appears to be no compelling reason for a common budget structure to serve each of these purposes.

There are, however, many reasons why a revised budget structure should be used by the Congress as the basis for decisionmaking. A primary reason is that the Congress, like the Department of Defense, should, and does, to some extent, think in terms of programs.

In the past, too much attention has probably been paid to detailed objects of expenditure, such as: maintenance costs, the location of National Guard armories; aircraft fuel and oil and the location and type of general officer's quarters.

The broader problem, however, and the most difficult job, is the job of choosing between programs and program levels. The only real question the Congress must answer annually is:

Should the Nation buy larger or small programs; and

Are the last increments of existing programs worth the cost?

No one will ever provide definitive, quantitative answers to these questions; yet we can, by revising our budget structure, improve its effectiveness as an instrument for analysis, planning and decision-making. A budget appropriately designed to meet the requirements of a rational decision process will not, of course, automatically insure the making of rational and sound decisions. It can, however, become a powerful influence in that direction by identifying and illuminating the significant alternatives.

If you direct your attention to the managerial potential of the present budget—specifically its employment as an instrument for analyzing, planning, deciding, controlling, and evaluating—its defects become obvious. Because it is the product of a desire to insure financial responsibility within an executive department's structure that evolved haphazardly through the vagaries of history and politics, it is not aligned with the requirements of a rational decision process.

Business managers learned long ago that they could not make resource decisions in an information vacuum. When a proposed new venture is being appraised, managers demand a comprehensive and detailed layout of all costs associated with the total commitment. They demand forward projection of the cost stream in the most realistic feasible terms. Lacking this, they are helpless to compare alternative investments.

This kind of information should be available to the Congress and should serve as a basis for making appropriate program decisions.

The second area I wish to comment on concerns our ability to implement and execute the chosen programs efficiently and effectively. In this connection I am especially pleased to appear before this committee today immediately following and with Dr. Robert Anthony who I had the pleasure to work with during the first portion of my assignment as Assistant Secretary. For, it was during Dr. Anthony's term as Assistant Secretary of Defense Comptroller that significant steps were taken to improve our abilities to manage our resources efficiently and effectively. Perhaps the most important of these steps was the introduction of responsibility accounting throughout the Department of Defense. With this major systems implementation job now complete, the new administration can place its emphasis on educating managers to use the information provided by these new systems to manage more effectively.

In addition to this leadership in improving budgeting and accounting for operations, Dr. Anthony strongly supported efforts begun by the Air Force over 4 years ago to receive more accurate, timely and meaningful information concerning the status of our major weapon acquisitions. These efforts, now broadly grouped under the project title—SAIMS—were directed at obtaining from contractors timely information reflecting development and production plans; data for measuring progress against these plans in terms of technical, schedule and work performance; and data for measuring and controlling the need for and flow of funds.

A most important element of the SAIMS effort, in my judgment, is the development of an effective performance measurement system. Air Force efforts to develop such a system, since the department of Mr. Ronald Fox, now Assistant Secretary of the Army, were, up to the time of my departure, led by Mr. A. E. Fitzgerald.

Inherent to this effort has been the development of a basic criteria which describes the minimum requirements a contractor's cost schedule and control system must meet. Although a DOD criteria was issued in late 1967, it is imperative that an effective guide for performance measurement be issued to explain: First, the intent of the criteria.

Second, to establish specific guidelines for evaluating contractor's systems, and, third, to provide guidance to each service for conducting demonstrations of contractor's systems. When and if the system is effectively implemented it could do much to provide the kind of program visibility essential for the program manager and the Congress.

Now, let me conclude my statement with this observation. Implementation and effective use, of any system, requires knowledgeable and creative people, and the most important task facing the Government leader today is to maintain an environment in which there can flourish not only individual genius but, more important, a collective capacity by people in an organization.

To accomplish this task the leader must consider these questions:

What are the basic, positive forces which must be operative for a creative governmental environment?

What generates their power?

What keeps them in balance?

What controls their survival?

What sets their direction?

I suggest the following answers: Power is provided by the existence of differences between individuals and groups; balance is provided by

understanding each other; survival is insured by the belief that rights must be matched by obligations; and direction is provided by each member's faith in individual growth.

That concludes my statement. I will be glad to answer any questions you may have.

Chairman PROXMIRE. Thank you both, gentlemen, for excellent statements. I think these are most helpful. And within the time limits that you had I think you both did a fine job.

Dr. Anthony, in your statement you pointed out the desirability of providing a recognition of the capital employed by a contractor. The implication is that it is not enough simply to compute the profit based and related to the sales, that you have to know how much capital is employed, together with the profit on sales, if you are going to determine fairly whether the profit is adequate, or is excessive.

I take it this is partly because in some cases at least very, very little of the total capital involved in a program comes from the contractor, and in some cases a great deal. But often the Government will own the plant, it will own much of the equipment, it will provide, with the program payments, in effect working capital, 90 percent progress payments. So the actual commitment by the contractor can be fairly minimal.

On the other hand, the contractor may provide most of these capital elements.

Did you have in mind that this should be known so that we would have some knowledge of the profits on a particular contract and defense contracts generally?

Mr. ANTHONY. It is more than mere knowledge, Mr. Chairman. A company is in business to make profit. And it is in business to make profit because people have put capital into that company on which they expect a return. The profit, therefore, should be related to the capital that people have put into the company. In an overall appraisal of a company the return on capital employed is the most important single measure. It therefore is equitable that in deciding on profit that a company should expect for working on a defense contract, some attention should be paid to the amount of the company's capital that is employed on that contract. This is much more than a matter of information to the Department or to the Congress; it is, I believe, the way in which contracts should be written.

Chairman PROXMIRE. You say that return on capital is the most important single measure. And I would agree that it is of very great importance. Is it not also desirable for the Congress to know, so that we have a better evaluation of the wisdom or effectiveness of our procurement policy, what the overall profits are of contractors in relationship to their capital investment?

Mr. ANTHONY. Yes, indeed, it is desirable. It is extremely difficult, of course, to find that information.

Chairman PROXMIRE. But it is desirable from the standpoint of knowing—they may not be adequate, and of course that provides penalties. At one time I recall that Secretary McNamara said that he thought that profits in some areas at least of defense contracting work were not sufficient to provide an incentive to do the kind of job that was desirable.

Obviously, they can be excessive in some cases also.

The reason I am asking these questions is because I have an amendment before the Senate now. I expect it to be acted upon possibly today or tomorrow, if not right after the recess. This amendment would provide for a profitability study by the GAO. This amendment I think is most necessary because we don't know now what contractor's profits are. We have the LMI study, which is an in-house study. You know about that. It has been challenged and it has been criticized by many because it is based on a sample, and it is not audited. And the feeling is that though contractors who had low profits responded and those with high profits did not.

So it is likely to be a biased sample. On the other hand, if we had a study by the GAO and the GAO says they can't make a study unless we pass legislation giving them the subpoena power in connection with this profit study, it seems to me we would be in a much better position to evaluate profits in relationship to the capital invested as well as the sales.

Mr. ANTHONY. Yes. To go back—

Chairman PROXMIRE. Would you agree with that observation?

Mr. ANTHONY. To go back to the essential point you made, it is extremely important that we have some feel as to whether the profits are adequate, that is, whether they are too high or too low. Secretary McNamara was particularly concerned, when we got the first LMI study in 1966, because it indicated that profits in defense industry were lower on the average than in comparable nondefense companies. If this were true in the long run, capital would tend to migrate out of the defense industry, and this would be a catastrophe for the country. And you therefore need a feel as to the adequacy of profits.

The LMI study was a limited study. I don't think it was biased because of the failure of low-profit contractors to respond.

Chairman PROXMIRE. High-profit contractors. You see, my contention is that the low-profit contractors responded, but the high-profit contractors are less likely to.

Mr. ANTHONY. I am sorry—by the failure of high-profit contractors to respond. I don't think this is so. And I think that the frequency distribution of responses in the study indicates that this is not so.

When I first got the LMI study, I saw that it reached a different conclusion than my own personal feel for the situation, and therefore I was quite skeptical of it. I made every test that I could make and had some other tests made also to give myself as much assurance as I could that that was a fair study. And I personally am convinced that the study gave the approximate facts as of 1966.

Chairman PROXMIRE. Isn't it proper that Congress should have an independent study based on audits and based on its own agency, the General Accounting Office, rather than on an agency allied very closely with the Defense Department and the contractors which I understand the LMI study was?

Mr. ANTHONY. No, not with contractors. LMI is related to the Defense Department.

Chairman PROXMIRE. I put the officers of the LMI into the record. And as I recall, they consisted in part of the Defense Department personnel and the former Army officials, and also of Defense contractors who had experience in that area. I don't say there is anything wrong with that, but I think we ought to just acknowledge and recognize who the LMI people were.

Mr. ANTHONY. I know the gentlemen, and I think they are gentlemen of extraordinarily high quality and integrity. The fact that some of them previously worked for Defense contractors did not affect their judgment in my opinion.

Chairman PROXMIRE. I agree wholeheartedly. But my only point is that an independent study would be more reassuring to those of us in Congress.

Mr. ANTHONY. Yes, I think this would be true. And the General Accounting Office is the logical office to make such an independent study. The General Accounting Office will have as much difficulty as the LMI people had, I think, because it is an extraordinarily difficult job to take the records of a company that works partly on defense and partly on nondefense and separate out how much of its total profit is attributable to each of these. It is an extraordinarily difficult job, but the General Accounting Office is an extraordinarily good organization, and I think they can do as good a job as anybody could do on this.

Chairman PROXMIRE. I would like to ask you, Mr. Nielsen—you did say in the course of your remarks that you felt that the Defense Department has been asking the right questions. And frankly, on the basis of some of the testimony we had earlier this year, I don't think they were asking the right questions. Perhaps they were within their limitations and the Budget Bureau wasn't asking the right questions. At any rate, former Budget Director Schultze testified to us that nobody, for example, questioned the wisdom of having such an enormous investment against the threat of a manned bomber attack from Russia, nobody asked if we really needed it, in view of the fact that Russia didn't have much of a manned bomber fleet—they have some bombers, they have about a quarter of what we have—as compared to the intercontinental ballistic missile threat and the submarine threat and other threats. And the kind of resources we spent in this area, in the judgment of Mr. Schultze, who is a very able man, seemed very unwise.

And I asked him why he didn't ask about it. And he said that this just didn't come out, and he felt it was unrealistic to question this in the kind of atmosphere that the President had to act in and the Congress had to act in.

Wouldn't that tend to contradict the statement you made, that the right questions are being asked?

Mr. NIELSEN. It certainly would. I would say that from my experience within the Department of Defense that kind of question was being asked, and has been asked repeatedly. And on the basis of those kinds of questions, decisions with respect to programs were made. I think all of the alternatives have been explored.

Chairman PROXMIRE. Including the alternative of just not needing the system at all?

Mr. NIELSEN. I think that those were always included within the alternatives. Maybe they were discarded very early in the decision process. But it seems to me from my experience that the widest range of alternatives was certainly asked for, and in many cases I think that widest range of alternatives was presented.

Now, why it didn't get through to the Bureau of the Budget I don't know.

Chairman PROXMIRE. My time is up. I will come back.

Congressman Conable?

Representative CONABLE. Thank you, Mr. Chairman.

You gentlemen are here today because I requested that you be invited. I also requested that a number of former Defense Department officials and various service department officials be invited.

I wonder, Mr. Chairman, if we could have made part of the record the invitations and their responses.

Chairman PROXMIRE. Without objection that will be made a part of the record. And I think it is very appropriate. I was going to put that in at the end of the hearing, but I think this is a good time to put it in. In other words, the letters which we sent out to the former Defense Department officials inviting them to appear and their response will be printed in the record at this point.

Representative CONABLE. Yes, if possible.

(The documents follow:)

LITTON INDUSTRIES,
Washington, D.C., July 7, 1969.

HON. WILLIAM PROXMIRE,
*Chairman, Subcommittee on Economy in Government,
Congress of the United States,
Washington, D.C.*

DEAR SENATOR PROXMIRE: Your letter of June 26 was incorrectly addressed to "Thomas H. Morris, Jr." in Beverly Hills and did not reach my attention in Washington, D.C. until July 3, 1969.

My time has been fully scheduled, and I will be unable to accept your invitation to testify.

Sincerely,

THOMAS D. MORRIS.

CALIFORNIA INSTITUTE OF TECHNOLOGY,
Pasadena, Calif., July 1, 1969.

HON. WILLIAM PROXMIRE,
*Chairman, Subcommittee on Economy in Government,
Joint Economic Committee,
Congress of the United States, Washington, D.C.*

DEAR SENATOR PROXMIRE: I have your kind invitation to participate as a witness in your continued hearings on "The Military Budget and National Economic Priorities." Unfortunately, I am afraid that my own schedule, which may call for me to be out of the country during much of the rest of the summer, will not allow me to participate.

As you are undoubtedly aware, my opinions on the decision-making process, cost-growth experience, and the other general subjects mentioned in your letter, are extensively documented. This process occurred during well over a hundred appearances before congressional committees over the eight year period covering my tenure as Director of Defense Research and Engineering and as Secretary of the Air Force.

If I can be of further help, please let me know.

Sincerely,

HAROLD BROWN.

DEPARTMENT OF THE AIR FORCE,
HEADQUARTERS AIR FORCE SYSTEMS COMMAND,
ANDREWS AIR FORCE BASE,
Washington, D.C., July 5, 1969.

HON. WILLIAM PROXMIRE,
Chairman, Subcommittee on Economy in Government, Joint Economic Committee, Congress of the United States.

DEAR SENATOR PROXMIRE: This will acknowledge receipt of your invitation to testify before the Subcommittee on Economy in Government.

I have learned that representatives of the Department of Defense will appear before your Subcommittee in the future who will be qualified to address the principal issues and provide information on the matters with which you are concerned. Since the broad scope of your hearings, as outlined in your letter, encompasses issues which extend beyond the responsibilities of my office, I respectfully decline to testify.

Sincerely yours,

CHARLES H. TERHUNE, Jr.,
Lieutenant General, USAF, Vice Commander.

DEPARTMENT OF THE AIR FORCE,
HEADQUARTERS AIR FORCE SYSTEMS COMMAND,
ANDREWS AIR FORCE BASE,
Washington, D.C., July 3, 1969.

HON. WILLIAM PROXMIRE,
Chairman, Subcommittee on Economy in Government,
United States Senate.

DEAR SENATOR PROXMIRE: I have received and carefully considered your invitation to testify before the Subcommittee on Economy in Government.

The breadth and scope of your hearings, as outlined in your letter, concern issues and policies beyond the purview of my office. I have been informed that representatives of the Department of Defense will appear before your Subcommittee in the near future who will be more qualified to address the principal issues with which you indicate concern. I therefore respectfully decline your invitation to testify.

Sincerely,

J. L. ZOECKLER,
Major General, USAF, DCS/Systems.

Representative CONABLE. The committee has been critical, of course, of the apparent waste and tremendous cost overruns in many cases that did not occur in a vacuum, but occurred during the course of the past 8 years. It seemed to us at the time that if we invited former administration officials doubtless we could learn more from their view of the errors, or at least what we had identified as errors, than we could by discussing this with experts and people who were not part of the process. I am most grateful to you gentlemen for coming this morning. And I appreciate the statements you have made. They seem to be primarily prospective.

I assume they are based upon your experience. It is obvious that you have had considerable experience to draw on.

First, I would like to ask, Mr. Chairman—we have been discussing the question of defense profits, and I have had called to my attention an excellent article in this month's *Fortune Magazine*, "Defense Profit, The Hidden Issue" by Allan T. Demaret. I am wondering if that, which deals at some length with the LMI study, could also be made a part of the record.

Chairman PROXMIRE. That series of articles in *Fortune Magazine* are among the best that I have read. I put most of them in the record a few days ago. They are excellent. In fact, I took the unusual step of reading every word on the floor in the editorials that talked about how our defense expenditures needed independent auditing.

Representative CONABLE. If that could be made a part of the record I think it would make a good addition to the record at this point.

Chairman PROXMIRE. Without objection.

(The article follows:)

REPRINTED FROM *Fortune Magazine*, AUGUST 1, 1969.

Defense Profits: the Hidden Issues

by Allan T. Demaree

Waving a finger at the rising earnings of General Dynamics, United Aircraft, Boeing, and General Electric, Senator George McGovern of South Dakota recently decried "this unconscionable assemblage of profits" as he introduced an "excess war profits tax" bill on the Senate floor. While chances of enactment are slight, the bill—and the rhetoric—reflect a prevalent belief in Congress and the country that defense profits are too high. Yet defense suppliers themselves are heard to argue that profits are inadequate—and the Pentagon has at times been inclined to believe them.

Considering the long history of debate over war profiteering, it is surprising that little solid evidence has been compiled on how high defense profits really are. Finding out is a formidable task. There is no such thing as a "defense industry" as industries are usually defined; today some 23,000 prime contractors supply the military with everything from missile guidance systems to the lowly combat boot. The vast majority are diversified businesses growing more so. And since they lump their military and commercial operations together in financial reports, it is impossible for outsiders to discern how much they're making or disperse.

A shattered opinion

Only one study has collected sufficient information to segregate the defense-business components of contractors' profits, sales, and capital. That study was conducted over the last few years by the Logistics Management Institute. The L.M.I. is a nonprofit think tank that Robert McNamara established to work for the Pentagon when he was Secretary of Defense. Its study includes most of the giant corporations usually considered part and parcel of the military-industrial complex—General Dynamics, Boeing, Lockheed, Grumman, General Electric, and others—plus a sample of medium-sized suppliers. The companies furnished data on a confidential basis, and the results are presented in averages that conceal individual company figures.

The study's most striking conclusion is that return on investment in defense business has been far from exorbitant in the Sixties. In fact, after a string of abundantly lucrative years, profits on defense work sank below the level of profits earned by all manufacturing companies in 1962 and have remained there (see chart opposite).

This is the case whether profits are figured as a percentage of stockholders' equity or of total capital investment, defined as equity plus long-term debt. Lately, profits on total capital invested have been falling unimpressively at a fraction over 7 percent after taxes. Moreover, defense suppliers' military work has been less profitable than their commercial business in recent years.

These figures shatter a widely held belief. While it has been known that return on sales in defense work tends to be low, it has generally been assumed that contractors earn handsome returns on their capital investment. One reason for this widespread opinion is that the government provides defense contractors with generous amounts of capital—including plant, equipment, and working capital—which means the companies' own investments may be small. So it was a surprise when profits on investment turned out to be relatively low in a study that took care to exclude from the investment base all government furnished capital as well as all the capital the companies had invested in commercial lines.

Attack in Congress

The fact that the L.M.I. study was financed by the Pentagon—and that it relied on the voluntary cooperation of industry—has led critics of the military and its suppliers to denounce the results as biased. A joint economic subcommittee, headed by Senator William Proxmire of Wisconsin, attacked L.M.I.'s report on grounds that it used "unverified, unaudited data," and that "contractors making high profits would naturally be reluctant to supply information and could simply choose not to participate."

Such criticisms have the ring of credibility, and in fact, they had occurred to McNamara and Robert N. Anthony, a Harvard Business School professor, serving as the Pentagon's controller when the study was conducted. Surprised that defense profits appeared to be so low, they ordered the report scrutinized for statistical soundness by Professor Robert F. Vandell, an expert in finance at the University of Virginia Business School. Vandell gave the report a clean bill of health, but Proxmire and his colleagues have continued to attack it.

They prefer to cite approvingly a study by Professor Murray L. Weidenbaum of Washington University, who was recently named an Assistant Secretary of the Treasury. This study shows that a sample of six defense contractors earned

higher profits than six relatively unprofitable commercial companies with similar sales volumes during two periods, 1952-55 and 1962-65. The legislators fail to mention that Weidenbaum did not separate the defense contractors' military and commercial businesses. Nor do they point out that in two of the years Weidenbaum excluded from his study, 1960 and 1961, the six defense firms, on the average, lost money.*

"The McNamara depression"

If profits have declined in the Sixties, what accounts for the trend? Increasing competition, for one thing. Growth in military demand for missiles, ships, and electronic systems was spectacular in the late Fifties, and profits were commensurately high. This lured hundreds of new, scientifically oriented companies into defense business. Commercial firms rushed to produce military goods. Aircraft makers, including Lockheed, Boeing, and United Aircraft, diversified into missileery. And components manufacturers such as Raytheon and Texas Instruments expanded into production of whole systems. As the Sixties dawned, clear signs of overcapacity were developing in the aerospace industry, which accounts for more than half of defense business.

Then came what some defense suppliers call "the McNamara depression." As Secretary of Defense, McNamara cut back the number of new weapon systems being bought. What the Pentagon did buy, it often bunched into big orders that would cover its needs for several years. With fewer sales targets to shoot at, defense suppliers competed vigorously for what was available, accepting low profits, even occasional losses, to win new programs that would keep their plants busy and engineering teams intact. Pressures increased for them to "buy in" to new contracts—i.e., to bid below expected costs in hopes of "getting well" with high profits from follow-on contracts.

Simultaneously, McNamara revolutionized procurement policies, encouraging even more competition among suppliers and forcing companies to shoulder heavier financial risks. He pressured them to invest in their own facilities rather than rely on the government. In 1956, for example, about 65 percent of the plant and equipment used by Northrop was government-owned; today that's down to 10 percent. The impact of this increased

**Weidenbaum chose from the 1965 FORTUNE list of the 500 largest U.S. industrials six companies that made three-quarters or more of their sales to the military and NASA. He compared their profits with six commercial companies that had nearby rankings in the 500. This limited sample and statistically questionable technique produced figures that Proxmire's joint economic subcommittee later relied upon as evidence that profits are "higher for the defense industry than for the manufacturing industry as a whole."*

THREE YARDSTICKS OF RETURN

investment has been dramatic, cutting the company's return on total capital invested to 6.5 percent from 13 percent. The drop in return occurred even though Northrop's net income tripled over these years, for its investment increased more than six times.

McNamara adopted price-competitive procurement wherever possible and this also took its toll. As the amount of price-competitive work increased, margins on it plunged. On the average, companies lost money on this business in 1963 and 1964, and margins were still tissue thin—less than 1 percent on sales before taxes—in 1966 and 1967.

Much of the Pentagon's business still remains noncompetitive, however, and the military argues that price competition is often impossible to achieve. In these cases, McNamara sought to make up for the lack of competition by stressing contract forms that increased the companies' risk and incentives for efficiency. He cut back hard on the use of relatively risk-free cost-plus-fixed-fee contracts, in which unforeseen cost increases are paid by the government. In their stead, he emphasized more fixed-price and incentive-type contracts; suppliers who had been accustomed to having the government pick up the tab for increased costs now found themselves paying for them out of their own pockets.

Recently, contractors have been complaining that the Pentagon has foisted too much risk on them by applying incentive-type contracts to advanced weapons that involve development work, such as North American Rockwell's computerized avionics system for strategic bombers and Lockheed's massive C-5A transport, discussed in the preceding article. The companies find it hazardous trying to estimate their own costs while they grapple with uncertainties at the leading edge of technology. And economic uncertainties in years of growing inflation have added to these hazards.

With pressure on profits, it's little wonder that the Sixties have seen the major defense companies spreading their risks. Merger was the route taken by North American (with Rockwell-Standard), McDonnell (Douglas), and L-T-V (Wilson and Jones & Laughlin). Boeing, United Aircraft, and others lowered their dependence on the military by expanding commercial lines. In the ten years covered by the L.M.I. survey, the defense companies' commercial sales nearly tripled, and by 1967 they were doing as much commercial as military business.

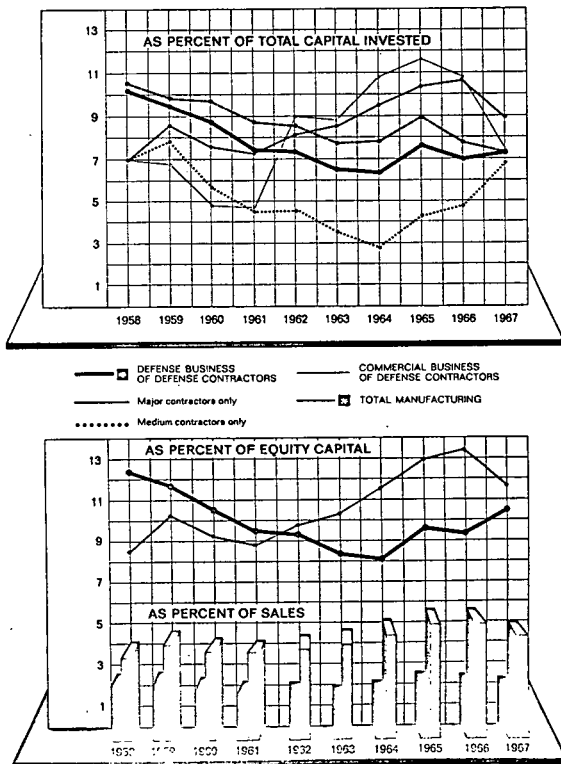
An incentive for inefficiency

Much is wrong with the peculiar system the Defense Department uses to negotiate the profits of its contractors, regardless of whether earnings turn out to be high or low. The main problem is that ever since World War I the government has negotiated profit rates as a

sample included twenty-three of the twenty-seven companies whose sales to the military exceeded \$200 million a year (major contractors) and seventeen of the fifty-five companies with sales of \$25 million to \$200 million (medium contractors). The profits on defense business of medium contractors have trailed those of major contractors largely because the government supplies its biggest contractors with more capital in the form of plant, equipment, and "progress payments." But during the Vietnam war the widening profit margins of the medium contractors have lifted their return on capital handsomely.

Since the early Sixties, defense contractors have found commercial business more profitable than defense business. The low profits on commercial business in 1960 and 1961 reflect large losses of a few companies (General Dynamics, Douglas, and L-T-V), as does the drop in commercial profits in 1967 (McDonnell Douglas).

The study covered companies that did more than 10 percent of their business with the military. Of these, the



continued page 128

Defense Profits: the Hidden Issues

continued from page 83

percentage of the contractor's costs. For example, if costs on a contract are expected to come to \$10 million and the profit rate is set at 8 percent, the company would have a negotiated, or "going-in," profit of \$800,000. Obviously, the higher the manufacturer's cost estimates under this system, the higher its negotiated profit. If the manufacturer knew it could trim costs down to \$9 million by cutting back on engineers or investing in automated equipment, there would be little incentive to do so, for this would trim its going-in profit down to \$720,000.

The realized, or "coming-out," profit may vary from the going-in profit, either up or down, depending on the efficiency of the contractor's performance and the validity of the original cost estimates, among other things. But the going-in profit is still critically important: the higher it is, the higher the coming-out profit tends to be.

Critics charge, justifiably, that the Defense Department's profit policy provides a perverse incentive to perform inefficiently. Because profits are computed as a percentage of costs, contractors are tempted to employ more engineering labor than is necessary, produce overly complex systems, invest less in cost-reducing equipment than they otherwise would, and lease equipment rather than buy it. The General Accounting Office found last year that seventeen contractors increased their costs on government contracts more than \$55 million by leasing land and buildings rather than buying them. This tactic—perfectly legal—appealed to the contractors because the rentals could be fully charged off to the government. If the properties had been bought, the charges to the government would have been limited to the far smaller amounts that could be claimed as depreciation.

Rewards for cutting costs

McNamara's move to use more fixed-price and incentive-type contracts was aimed partly at blunting this tendency for defense contractors to expand their costs. On an incentive contract, if a company shaves costs below the negotiated level, it can keep a portion of the savings as extra profit—say, 30 cents on every dollar saved. If, on the other hand, costs exceed the negotiated level, the company is penalized 30 cents for every dollar of overrun. The firm fixed-price contract provides the maximum in cost-cutting incentive, since the company keeps every dollar of underrun and loses every dollar of overrun.

These contract forms are a marked improvement over cost-plus-fixed-fee, which provides neither rewards for cost savings nor penalties for overruns. But they have been only marginally successful in overcoming the cost-increasing incentives of the Pentagon's profit system. Any incen-

tives to cut costs apply only after the contract is negotiated, not before; it still pays a company to negotiate the highest-cost contract possible. In fact, a study of Air Force incentive contracts by economist Irving N. Fisher of Rand Corp. indicates that cost underruns usually occurred not because the companies increased their efficiency and actually cut costs, but because they were successful in negotiating contracts with inflated cost estimates in the first place.

As in other industries, the most insistent pressure forcing contractors to hold down costs is price competition. But while McNamara greatly increased price competition, more than half the Pentagon's procurement remains noncompetitive. Many products bought by the military are supplied by only one company. On major systems, strong competition may exist in the research and development phase—so strong, in fact, that contractors feel forced to buy in by bidding extremely low. But once a manufacturer wins that round, he usually becomes a sole-source supplier with whom the Defense Department must negotiate follow-on contracts on a noncompetitive basis. To combat this problem, the Pentagon devised the "total-package procurement" contract, where companies bid at the outset to perform both R. and D. and production. The total-package concept has run into problems of its own, however, as its initial use with the C-5A has shown.

An advantage for the giants

Pentagon profit policy also leads to marked inequities among companies. Since profits are keyed to costs, the size of a company's capital investment is largely disregarded in determining the profit rate. Companies with low investment relative to volume tend to fare a lot better, in terms of return on capital, than companies with high investment. Striking variations in capital intensities among suppliers can be seen from the ratio of their costs to total capital invested. Last year General Dynamics had a phenomenally high cost-to-capital ratio of 6.4, which means that for every 1 percent profit it earns on costs, G.D. makes 6.4 percent on investment. At the other end of the spectrum stand such companies as Hercules Inc., a chemical company with a cost-to-capital ratio of 1, and Varian Associates, an electronic-components manufacturer with a ratio of 1.2. For them, a 1 percent profit on costs means a mere 1 percent or 1.2 percent on invested capital.

Pentagon policy also makes for inequities between the biggest defense suppliers and the medium-size companies. The government furnishes its major contractors with far more interest-free working capital in the form of "progress payments," which reimburse them for costs they incur on a pay-as-you-go basis. This discrimination occurs because the big contractors hold most of the long-term, big-dollar contracts, the only ones that qualify for progress pay-

ments. Lockheed, for example, has received progress payments on the C-5A of \$1.5 billion, more than the G.N.P. of Uruguay, even though the plane isn't yet operational. These liberal doses of interest-free money mean that the biggest suppliers furnish only about two-thirds as much of their capital as medium-size ones, and far less when compared with small contractors, which often get no progress payments at all. The added leverage this gives the giants naturally boosts return on investment.

Revolution afoot in the E Ring

The profit system was even more arbitrary before 1964, when McNamara initiated a new policy called the "weighted guidelines." Before that there was no discernible logic to the way profits were negotiated. Rates were often awarded individual contractors on the basis of historical patterns, with little regard to whether the job called for sophisticated engineering or simple metal bending. A prime contractor got the same rate whether he performed all the work himself or farmed it out on subcontracts, in which case his investment would be very small and his profits would be pyramided atop those of his subcontractors. Now, in negotiating a profit rate, Defense Department contracting officers are supposed to weight various cost factors. A company can earn from 9 to 15 percent on the cost of engineering labor, but only 5 to 9 percent on manufacturing labor, and 1 to 4 percent on purchased parts. Higher negotiated rates go to contractors who undertake more difficult tasks, assume greater risks, and have good records of past performance. While this profit policy seems more reasonable than earlier methods, it still retains all the disadvantages of a cost-based system.

For several years now, plans to break the heavy cost-orientation of the profit structure have been bandied about the E Ring of the Pentagon, where policy is made. But despite the manifest need for change, progress has been slow, at least partially because of opposition from such high-volume, low-investment suppliers as Lockheed and Raytheon. One idea is to base a part of a contractor's negotiated profit margin on the assets it has invested in performing government work. The theory is that this arrangement should reduce inequities and improve contractors' incentives to invest in cost-saving plant and equipment.

The proposal was presented to the Pentagon's Industry Advisory Council, a group comprising top executives from a dozen or so major companies, such as Litton, Ford, Boeing, and Northrop. Beforehand, Pentagon officials had computed what the proposal's effect would be on each of the companies whose executives were on the council. They predicted that the companies with relatively low investments would oppose the plan, and they were right with but one exception. "This was a company," recalls Robert Anthony, the former

Defense Profits: the Hidden Issues

continued

controller, "that had made an error in its own calculations. As soon as it discovered the error, it shifted its position." The proposal has been hung up for several months while Pentagon officials tried to figure a way around these objections.

The case for lower profits

The question whether profits on defense contracts are at the "right" levels is critical for the military, the defense industry, and the nation. If they are too high, the nation is wasting resources. And if they are too low, capital may flow out of defense business, and the armed services will be forced to rely on fewer—and perhaps second-rate—sources of supply.

During the Johnson Administration the figures worked out by the Logistics Management Institute persuaded McNamara and Anthony that defense profits were too low. Late in his tenure, McNamara took steps to soften the downward pressure his policies were exerting on profits. Anyone who walks the corridors of the Pentagon these days gets the feeling that the McNamara viewpoint still lingers. But the Nixon Administration is officially noncommittal, what with the current wave of public criticism. The words of Barry Shillito, the Defense Department's top procurement official, portray the delicacy of the Pentagon's position: "We've said nothing about whether profits are adequate. And," he adds with a nod toward Capitol Hill, "we're not about to."

The issue of whether profit levels are "right" should no longer be avoided. Even though the average is low by the reckoning of the Logistics Management Institute, it is a mistake to conclude from this alone that the Pentagon should do something to raise over-all profit rates. While averages are important, they cover up significant differences among companies in widely varying industries—electronics, aerospace, shipbuilding, and others. Moreover, there

have been few signs of companies' turning down military business even at current profit levels. In fact, suppliers appear to have been investing in defense business faster than military demand has grown.

In the debate over whether defense profits are too high or too low (or, as almost nobody argues, just right), the most important question is one the Pentagon has sidestepped for years: What is an adequate profit on defense work? Should defense profits be equal to those in commercial durable-goods industries? Or higher? Or lower? The Nixon Administration has done little more than broach the question to the Industry Advisory Council, hardly a disinterested body.

A crucial factor to consider is risk. Higher risks justify higher profits, and contractors generally contend that defense is a risky business. They cite the volatile fluctuations in military demand and the ever present possibility that contracts may be canceled "at the convenience of the government" (as in the case most recently of the Air Force's manned orbiting laboratory). Many economists reply that risk is really quite limited in defense business. If a contract is canceled for convenience, the contractor is compensated; he has lost a chance for profit, not his own capital. General Dynamics, for instance, was hit less hard by the loss of its \$200-million Navy F111-B contract last year than by its celebrated failure in 1961 to crack the commercial jet market, where the company's own capital was at stake. If defense contractors really do face less risk than manufacturers in general, an argument can be made that their profits should be lower—closer to the level of public utilities, i.e., around 7 percent on total capital invested.

A second issue to be considered in judging the adequacy of defense profits is whether contractors are compensated in ways that aren't generally considered "profit." The government sponsors enormous amounts of military research and development, \$66 billion in the past decade. If a company can apply this R. and D. to commercial products such as jet planes or

television, it will reap a gain that doesn't show up in its profits on defense business. A notable example of this is Boeing's 707 commercial jet, which employs design techniques Boeing developed in supplying the Air Force.

A contractor can also benefit when defense work absorbs costs from commercial business. In cost-plus and incentive contracts, the government pays a share of the contractor's general and administrative expenses and overhead, the exact amount figured as a percentage of the costs that the company incurs on military work. So contractors have some incentive to run up their costs in order to get higher government payments for G and A expenses and overhead, thereby reducing the amount borne by their commercial business.

Another advantage for contractors is that they are allowed to use government-supplied plant and equipment for commercial purposes. The government supplied TRW Inc., for example, with a \$1,400,000 forge press to handle orders for jet-engine blades. Then the Air Force cut back on its orders and TRW used the big press for commercial work more than three-quarters of the time.

What needs to be done

Circumstances like these, which quite obviously make defense business unique, must be carefully weighed before the Pentagon passes judgment on whether profits are too high or too low. Hysterical charges about "unconscionable profits" earned by defense suppliers make newspaper copy, but they confuse national policy making by obscuring the real issues. The real need is for the Pentagon to recast its procurement policies in a way that will encourage more efficient production and reduce inequities among its suppliers. Also, the Pentagon must grapple with the central question—what is the "right" level for defense profits? Until it does, it will lack the framework for a rational procurement policy, and any attempts it makes to raise or lower profits are likely to be misguided.

END

Representative CONABLE. I noted one thing, Mr. Nielsen, in your statement that seemed to imply that program level questions had not been made previously in the context of some kind of economic constraint. You say that with the new Administration, these questions may be asked within the context of economic constraint. Isn't there built into your whole process a high degree of economic constraint? I am wondering exactly what you meant by these references?

Mr. NIELSEN. There ultimately certainly is, that is correct. The system has operated on the early submission of the plans from the Joint Chiefs of Staff; these are based on requirements of the Joint Chiefs of Staff as they interpret our commitments. As these requirements are priced out they reach a rather staggering figure. So the process has been one of reducing the requirements figure down to some kind of meaningful Department of Defense budget.

The question is, who does this, and when is it done. In the past it has really been done in December at the time the deadline runs out and you have to submit the budget to the Congress.

Now, for the first time—at least it is my understanding it will be the first time—some kind of economic guidance is to be inserted into this process early in the year, so that not only will the Joint Chiefs of Staff submit a requirements budget or a requirements program, they will submit a program in response to some economic guidance.

Now, this causes certainly many problems, because they have to choose between many of these programs. So that is really the change—and it was strongly encouraged, I might say, by myself and others within the Air Force.

Representative CONABLE. Thank you.

I didn't understand what you meant by that. I thought perhaps you were talking about the new economic constraint dictated by skepticism in the Congress.

Mr. NIELSEN. No.

Representative CONABLE. I have been trying to think of what would be the best course of questioning for gentlemen with the experience you have to draw on. It seems to me that it might be illuminating to ask questions about one of the programs which has been heavily criticized by the committee—and that is the C-5A program—and to try to understand exactly what happened, and why, with respect to the C-5A program.

Now, many of these things occurred before you were Assistant Secretary, Mr. Nielsen. I think Mr. Anthony must have from his vantage point as Comptroller a good deal of information about where the decisions were made and why they were made the way they were. It appears from testimony we have heard that the Pentagon failed to get reliable aircraft designs from Lockheed at the start of the C-5A program, and later we had to get into costly redesign of major components in order to meet the contract requirements. From your experience, Mr. Anthony, would you say that is a fair statement? Could the failure have been prevented back in October 1965 when contracts for the airframe and the engine were awarded?

Mr. ANTHONY. I can't speak from personal knowledge on this, Congressman. I had just come in 1965, and actually it was not until 1967 that the Comptroller became closely involved in trying to track

the performance of procurement of major weapons systems. This was a quite new venture for the Comptroller. And indeed it was partly because of that venture and the information it turned up that some of the things that the committee has heard testimony about previously came to light. I just can't comment about the situation in 1965.

Representative CONABLE. As Comptroller you were reviewing that after the fact largely.

Mr. ANTHONY. No; in 1965 we were not in that information stream at all. You see, I came in September 1965, and everything had been done, I think, except the actual signing of the contract prior to that time. This process started in 1964, quite awhile before I came.

However, to generalize, and not being specific as to C-5A, I don't think that it is a fair generalization to say that cost overruns were greater in the last 8 years than they were previously. My impression is that they were less in the last 8 years overall. A study was made, I think, of experience during the 1950's, which showed overruns of 300 to 700 percent of original estimated costs. These figures are much greater than the overruns on C-5A, or on typical experience in the 1960's.

Representative CONABLE. Are you saying that this is an inevitable part of the process, then, and that actually the things of which this committee has been so critical represent improvements over previous practice?

Mr. ANTHONY. Oh, yes, I think they definitely represent improvements. Overruns are not inevitable. Differences between estimated costs and actual costs are inevitable, simply because no human being can estimate, when you start a complicated new weapons system, what it is really going to cost. That doesn't mean that they necessarily are overruns. The actual costs might be higher or they might be lower, but you can be sure that they will be different from the costs you estimated at the beginning.

Representative CONABLE. Perhaps you will have to make the same sort of answer to my second question. It seems generally agreed now that few of the parties involved in the contract competition for the C-5A, including the Air Force, seriously expected Lockheed to meet its cost targets.

In fact, this belief is included in a recent Air Force review of the C-5A program report. Did the Air Force warn Lockheed at the time it submitted its contract estimate that it was being overly optimistic?

Mr. ANTHONY. No—I have no knowledge of any of the incidents of 1965, or 1966, for that matter.

Representative CONABLE. Mr. Nielsen, you must have reviewed this rather extensively in your official capacity. Do you know if Lockheed was warned that it was overoptimistic at the time?

Mr. NIELSEN. No, it was my understanding that they were not.

Representative CONABLE. Does that mean that the Air Force expected substantial cost overruns on the contract or that Lockheed would have to pay the difference in reduced profits?

Mr. NIELSEN. The second part of that statement I think many people subscribed to in the systems command that I talked to, that is, if

you looked at target cost and you looked at target price, Lockheed was expecting a lower target profit, which meant they expected a higher target cost than was originally included in the contract. But I think in further response that many people did expect that Lockheed would exceed its cost from the beginning.

Representative CONABLE. Lockheed has had reduced profits, of course, as a result of this.

Mr. NIELSEN. Yes.

Representative CONABLE. We have had very extensive overruns just the same.

Mr. NIELSEN. Yes.

Representative CONABLE. The operation was extremely costly for all parties involved, and yet apparently it was undetected, or at least undetermined at the time.

Now, the C-5A contract included a repricing formula which has been described by this subcommittee as a blatant reverse incentive. Given the experience with this contract element, would you suggest that it be excluded from future contracts—I am sure you would—or do you believe it can be altered to provide the incentive for a contractor to cost control as well as partially compensating for unknown cost features?

Mr. NIELSEN. I would perhaps argue with the word blatant. But I certainly would agree that it does contain the potentials of a reverse incentive. It seems to me that that kind of formula pricing is not appropriate within these kinds of contracts. There should be another basis on which to base future negotiations, especially of this kind. That is merely my personal observation on that situation.

Representative CONABLE. My 10 minutes are up, Mr. Chairman. I would like to pursue this line of questioning later.

Chairman PROXMIRE. Mr. Nielsen, you made the very interesting contention that the Joint Chiefs are now under some kind of economic constraint. This came as a surprise to me. The staff tells me that they have heard the rumor that something like this was being discussed, but I hadn't known that it had been formalized or declared, and that this was a method of providing economic constraint for the Joint Chiefs when they expressed their joint strategic objectives plan.

Mr. NIELSEN. May I clarify that?

Chairman PROXMIRE. Yes.

Mr. NIELSEN. This was under discussion only. I am not clear as to what further action has been taken. The suggestion was made even before the new administration had taken over. This was the result of my review with Dr. Brown, that there be changes made, and this was a part of our suggestion. I am not clear as to what actually has been done, however, in revising the system itself, whether in fact they have carried through on that.

Chairman PROXMIRE. What did you have in mind for economic constraint? In the past I understand the Joint Chiefs have come up with something like a budget of \$105 billion, something like that, in that area, every year, each year, and the Secretary cut it down—obviously the Secretary is under economic constraint, he checks with the President and the Budget Director very closely, and they attempt to have a budget that meets a certain objective usually, or I would think they

would. In what way would this be given? Would the Joint Chiefs be told that the budget would have to be within a certain size?

Mr. NIELSEN. I would envision it that way. I think that you might start the planning process with a range of alternative budgets, or you might give them more than one. But it would be 10 percent of the gross national product, which in this case would be roughly \$80 billion, perhaps, and then 5 percent above and below the \$80 billion. So that you might ask for a budget, or submission of programs, that would total \$4 or \$5 billion below, and \$4 or \$5 billion above. It seems to me that in this questioning process one would then identify the programs that would drop out first, and you would also begin to identify the programs that one would add first.

Chairman PROXMIRE. So what you are really asking for is a kind of priority system?

Mr. NIELSEN. That is correct.

Chairman PROXMIRE. Would this priority system be cleared with the Congress, or do you think that would be appropriate.

Mr. NIELSEN. I think that would be appropriate, yes.

Chairman PROXMIRE. I think that would be very helpful. Of course, we may fear that anything they didn't put on the top priority we would knock out, with some justification. There would be a terrific argument on the floor saying that this wasn't a high priority, and even the military felt that they could get along without it. There would be that problem involved. On the other hand, I think the frankest kind of disclosure to the Congress makes for the best overall operation.

I am not sure that we could reconcile those two difficulties.

Let me ask you—you make a very strong statement here that seems to me to be just exactly what I am interested in. You say:

When a proposed new venture is being appraised, managers demand a comprehensive and detailed layout of all costs associated with the total commitment. They demand forward projections of the cost stream in the most realistic, feasible terms. Lacking this, they are helpless to compare alternative investment.

Now, this kind of information should be available to Congress, and should serve as a basis for making appropriate program decisions.

Now, what we have gotten in almost every program is that analysis based on what so-called historical costs, the historical experience for this kind of an operation. This is an easy method to operate on, the contractors like it, the Defense Department likes it, and there is no real pressure, at least not the kind of pressure which you would have if you had a should-cost operation, if you had expert technicians determine how much a program ought to cost if you adopt real efficiencies and are tough and hard-nosed all the way through. We have had some witnesses, including Mr. Fitzgerald, to whom you favorably refer, who have said that this is one of the real problems of defense procurement, the failure to have an effective should-cost method apply to most programs.

It is rarely applied. It is strongly resisted by contractors. Would you feel that this is desirable to try and push this along; is this what you had in mind?

Mr. NIELSEN. I have discussed the question of should-cost at some length with Mr. Fitzgerald. I would think that Mr. Fitzgerald has should-cost in mind under different circumstances. When I am talking

here in terms of total program costs, or forward projection of cost streams, it is in response to your previous question to the Department of Defense related to the AMSA, what is going to be the cost of that program. Today I don't believe there is anyone that can come up with the kind of should-cost study that Mr. Fitzgerald would have in mind.

On the other hand, it does say to me that we should give the best possible long-range projection of total cost of each new weapons system, which would then be the base line from which we would measure. As I have discussed it with Mr. Fitzgerald, it seems to me should-cost comes in at the time we have specific contractor proposal, or we have specific changes to a proposal, and we would be looking at the questions of the amount of direct labor, the efficiency of that direct labor, the amount of overhead, some of the questions that Dr. Anthony got into. So I think he would apply should-cost primarily to on-going contracts, or to contracts that are now in the process of negotiation. And I draw a distinction between the kind of program costs I referred to in my statement and where he would use should-cost.

Mr. ANTHONY. Could I make a comment on that?

Chairman PROXMIRE. Yes, indeed.

Mr. ANTHONY. I think the should-cost technique is an extremely important one. It has to be applied selectively because it requires a very high type of manpower in order to make a good study. And it takes a lot of manpower. I think the first time when we tried to do it, which was in the case of the F-111 engines, our team consisted of about 50 people. And they were 50 top people, drawn from all over the establishment. You just don't have the resources to put that kind of team on every job.

Chairman PROXMIRE. How big a contract was that?

Mr. ANTHONY. This was about a billion dollars worth of work.

Chairman PROXMIRE. Fifty people is pretty small potatoes in terms of cost when you are talking about a billion dollar contract.

Mr. ANTHONY. It isn't the 50 bodies—

Chairman PROXMIRE. Fifty of the best experts you can find is still a modest investment for the billion dollars.

Mr. ANTHONY. Indeed it is. I am merely saying that you just don't have too big a reservoir of such people. But I am very much in favor of the should-cost kind of study in situations where we think there is a good opportunity to cut the cost down. I am only suggesting that we should be selective.

Chairman PROXMIRE. All the testimony we have had from Defense Department officials—Mr. Rule, Mr. Fitzgerald, and others—of the evidence we have got, indicates that there is a resistance on the part of the contractors, a tendency on the part of the defense procurement officials and the contractors to see things alike very often. It seems to me we are not going to get "should-cost" unless there is some kind of action either by the contractor, by the President or by some agency or some force outside of the Defense Department.

It is not good enough just to talk about. And I can see the advantage intellectually. But I just wonder if you are going to put this into effect on defense contracts unless we do something about it.

Mr. ANTHONY. The first study was only made in 1967. It paid off and paid off well. I think that Defense management itself will encourage such studies in the future.

Chairman PROXMIRE. Were you involved in any way in the should-cost study performed on the Pratt & Whitney engines for the F-111?

Mr. ANTHONY. Yes, indeed. I was the one that was arguing very hard to have such a study made.

Chairman PROXMIRE. Would you say the results of this study were useful to the DOD?

Mr. ANTHONY. I think the results of this study were great.

Chairman PROXMIRE. And they did save money?

Mr. ANTHONY. I don't know the final outcome, but our estimate at the time was that the minimum amount of saving resulting from suggestions made by this team was \$100 million.

Chairman PROXMIRE. Was the should-cost study performed initially by a private consultant firm called Performance Technology Corp.?

Mr. ANTHONY. There was a preliminary, sort of an ice-breaking kind of study, a small one made by Performance Technology, which was an excellent company, but with limited resources. The study to which I refer was an official study by the Defense Department. Gordon Rule was in charge of it. And that was a much bigger effort than the Performance Technology study.

Chairman PROXMIRE. Did the Performance Technology study contribute to the overall study and the cost reduction which you mentioned?

Mr. ANTHONY. Very greatly, yes.

Chairman PROXMIRE. On your knowledge did the DOD ever hire the PTC to do any additional or subsequent studies of this type?

Mr. ANTHONY. I am not aware that they did.

Chairman PROXMIRE. Why didn't they?

Mr. ANTHONY. I don't know.

Chairman PROXMIRE. It seems to me that with this kind of a result that it would be logical for them to say, let's try this again and again and again and again.

Mr. ANTHONY. I think it would be good to have the Performance Technology Corp., which was a small organization, but an excellent one, and it would be desirable to hire other independent outside people to make such studies. I guess one problem is that in recent years the appropriations for this kind of work, outside consulting work, have been pretty sharply restricted; and there is a special limitation on such work.

Chairman PROXMIRE. Restricted by the Congress?

Mr. ANTHONY. By the Congress, yes.

Chairman PROXMIRE. Did the Budget Bureau go along with requesting the amount?

Mr. ANTHONY. Yes.

Chairman PROXMIRE. And the Congress restricted it?

Mr. ANTHONY. Congress placed restrictions on an item called outside studies. And that may have had a bearing on it.

Chairman PROXMIRE. We will check into that.

My time is up. But I would appreciate it, Mr. Conable, if I could ask just one more question, because it is right on this line.

The Air Force performed a should-cost analysis of the Mark II Avionics. We obtained a copy of this study. I understand that after it was performed in December 1967 the Air Force decided not to use

the results of these efficiency studies. First, I want to know, what was the rationale for not using the the results of that study, and in your opinion how good was the study in terms of factual identification of avoidable inefficiencies?

I think that question is for Mr. Nielsen—unless you would like to comment on it?

MR. ANTHONY. I don't think the date is 1967. Isn't it later than that?

CHAIRMAN PROXMIRE. I have December of 1967 here.

MR. ANTHONY. I thought it was later. OK.

MR. NIELSEN. AS I recall, during December of 1967, just before I assumed the office, one of the first meetings I did sit in on was a review of the should-cost study. The should-cost study was performed essentially by an in-house team, as I recall, from the Air Force systems command concerning the Mark II program.

In my judgment the results of that study were used. The primary problem with the Mark II as I recall became one of questioning the technical baseline rather than the cost baseline. There was a strong disagreement between the Air Force and the contractor as to the technical baseline—and I am not sure in my own mind at this point that that question has been fully resolved—by technical baseline I mean: Did you at this time agree to build this piece of equipment for this cost?

I think the answer of the contractor was, "yes sir, we did, and what you are asking us to build now is not the same piece of equipment," and, therefore, a substantial amount of these increases should have been in our original cost. That was strong disagreement between the Air Force and the contractor, and a strong position was taken by the Air Force.

When I left as far as I know that matter had still not been resolved, and it may have to go further through whatever appeals processes are necessary.

The should-cost study, in my judgment, was not as complete an effort as could have been made. We did not use an outside consultant, we used an in-house staff. We were somewhat critical, that is, both my successor, Dr. Marks and I, concerning the nature of the study, but we didn't pursue a further study on a should-cost basis, in view of the very difficult technical baseline question.

CHAIRMAN PROXMIRE. My time is up.

MR. CONABLE?

REPRESENTATIVE CONABLE. Mr. Anthony, as early as 1966, apparently, Air Force investigators were saying that the C-5A costs were running very high. Do you recall when it became apparent that the costs of the program would be much greater than the original contract estimates?

MR. ANTHONY. The system on which the controller started to try to collect such information didn't begin until late 1967. And it wasn't until sometime in 1968, when I began to get information from that system, that I had knowledge of this situation.

REPRESENTATIVE CONABLE. You mean despite the fact that you were approving outlays on contracts you were not aware of the fact that the outlays on the C-5A were exceeding the estimates?

MR. ANTHONY. That is correct. It isn't correct to say that I approved outlays on contracts. I didn't.

Representative CONABLE. What is the function of the Comptroller with respect to funding? I am sure you have more than simply a bookkeeping function?

Mr. ANTHONY. Yes, indeed. But our function is to authorize the service to make a contract for a certain amount for these aircraft in this case. And having made the contract, we did not until late 1967 have a system that tried to compare the actual costs with the planned costs as the contract was proceeding. We knew at the end, all right, but not as it was proceeding.

Representative CONABLE. Who does exercise this oversight function?

Mr. ANTHONY. The contracting officers who are in a different chain, the so-called installations and logistics chain.

Representative CONABLE. Why would there not have been made public or made available to Congress estimates that indicate a serious cost overrun as early as 1966?

Mr. ANTHONY. I don't think, from what I know of the situation that they have very good evidence of this in 1966. You see, in order to get this information while the contract is in process, one has to have a way of comparing actual costs of the work completed with the planned costs of that portion of the work, not of the whole contract. And that is an essential feature of the system that we have been trying to get going: I think we are gradually succeeding in getting it going.

Indeed the committee has been of great help in stimulating this work for us.

Representative CONABLE. In other words, it would be your opinion that nobody really knew these cost overruns were as serious as they are?

Mr. ANTHONY. That is correct.

Representative CONABLE. Simply because nothing was scheduled, a schedule of performance against cost had not been made up to provide this kind of oversight?

Mr. ANTHONY. That is correct. That is a quite recent development. And it still has got a long way to go before it is all worked out.

Representative CONABLE. That seems incredible to me.

The C-5A program was the initial application of the new approach to procurement called the total package procurement concept.

Now, there has been a lot of criticism of the C-5A program. Do you still think that this is a good method of defense procurement?

Mr. ANTHONY. That is a very difficult question. The general concept is certainly sound. Previously when we made a contract for research and development, that committed us to a certain contractor, so we were, in a sense, at his mercy for the production phase of the acquisition. The idea of total package procurement is that we try to make the whole deal at the beginning. The danger of it is that you don't know what the costs are going to be at the early stage.

The particular contract on C-5A tried to reconcile these two things by allowing for a failure to estimate the costs properly at the early stage. I don't think, from hindsight, that the way that contract has worked out is the best way. Indeed, I think the Air Force is now

changing, or at least contemplating changing, the contract in order to take what it has now learned into account.

I think the total package procurement idea is certainly good on a procurement which does not involve a major advance in the state of the art, that is, where you can make a quite good estimate of what the costs are going to be.

Representative CONABLE. However, most major weapon systems of course do involve a large amount of research, and therefore cost is difficult to predict.

Mr. ANTHONY. That is the trouble.

Representative CONABLE. So you wouldn't say the C-5A was an example of poor application of a valid principle?

Mr. ANTHONY. No. The C-5A, remember, was the first trial of this method of contracting. I do think there is something to it. I think that there is in this concept something that can be applied to future concepts, but it has got to be modified.

Representative CONABLE. Apparently it is not a good approach for helping to control costs.

Mr. ANTHONY. If it hadn't gotten into the escalation feature above 130 percent, it would have been excellent; that is, if the costs could have been estimated closely enough so that they stayed within the band of 100 to 130 percent, it would have been an excellent incentive.

Just because costs got outside that band that it turned out to be not too good an incentive.

Representative CONABLE. Would it be fair to say that the total package procurement reduced the Air Force and Lockheed management visibility because of inadequate contractor data, reduction in reports required from the contractors, and the untested feature of the total package procurement then.

Mr. ANTHONY. Not at all, no.

Representative CONABLE. It wouldn't be fair to say that?

Mr. ANTHONY. No.

Representative CONABLE. Did it reduce visibility?

Mr. ANTHONY. Not at all. Indeed, that is a completely different question. The efforts to increase visibility are quite independent of anything in the total package procurement concept. These efforts are the ones I described a little earlier.

Representative CONABLE. Certainly, though, visibility is enhanced by having separate research and development contracts even though it slows down the process?

Mr. ANTHONY. No—I am not sure that I see why this would be so. Even in the C-5A contract there are separate amounts for research and development and for production. Those separate amounts are just as visible as they ever were.

Representative CONABLE. You would say, then, would you, that the C-5A contract provided better visibility than most of the previous weapons systems?

Mr. ANTHONY. No, sir, I just say that the visibility question is a quite separate question. You get better visibility by a better control system. And that is what we have been working on recently.

Representative CONABLE. Of course it is something that we are interested in here in Congress.

Mr. ANTHONY. Indeed, yes.

Representative CONABLE. We want to avoid this type of overrun. Whether or not it is more than it may have been previously, it certainly is more than we want to have, simply because it makes it very difficult to assess priorities when you don't know what something is costing or is likely to cost somewhere down the road.

Mr. ANTHONY. Yes, indeed. As a direct result of the work of this committee, the Congress is now getting data on 31 weapons systems, the same kind of data that you are talking about. This is a very good development, I think.

Representative CONABLE. You would disagree, then, with the Air Force review of the C-5A program dated July 1969, a finding—this is under item No. 24—that the limitations in Air Force contractor management visibility were in part due to “inadequate contractor data, reduction in reports acquired from the contractors under the contract, policy of disengagement, and the untested feature of the total package procurement.”

Mr. ANTHONY. Yes.

Representative CONABLE. You don't agree with that?

Mr. ANTHONY. I do not.

Representative CONABLE. And you feel that what you have said is adequate explanation of your disagreement? Or is there anything you would like to add?

Mr. ANTHONY. I am not familiar with this report at all. We are gradually working toward a system which has much less paperwork than there has been before, and people can say that, since it has less paperwork, it has less visibility. But this really isn't so. It is a system that provides more visibility because it provides the right kind of information. We have a long way to go, but I think we are working toward it. This new system is beginning to work on things like C-5A.

Representative CONABLE. Would you agree with his analysis, Mr. Nielsen?

Mr. NIELSEN. Not exactly. I think that the total package did result in less visibility. Now, what the causes were I think are not too clear. One of them, though, is that it seemed to me the Air Force through this concept felt the contractor had more responsibility, therefore they could disengage. At the same time that they disengaged they did not have the kind of visibility through the control system which Dr. Anthony described. So before we took those steps in disengagement it seems to me we should have had a proper kind of information.

We didn't have it at that time.

Representative CONABLE. Thank you, Mr. Chairman. That ends my questioning.

Chairman PROXMIRE. I would like to ask you, with reference to cost standards, Mr. Anthony, you say:

Congress has already instructed the Comptroller General to investigate the feasibility of writing uniform cost standards. I think this is an area of great promise.

This was an idea that I have pushed very hard, and I believe in very strongly. As you know, Admiral Rickover has testified on this. And he has indicated that he thinks we can save \$2 billion a year in our procurement if we can get uniform cost standards.

On the other hand, we get an objection from some Members of Congress and from some people in the Pentagon and in the industry that this is impractical, that you can't really get uniform cost accounting standards, you can't put them into effect. You are expert in this area. And I understand you have done some work on this specific problem. Could you elaborate on this a little bit?

Mr. ANTHONY. I should say first that I am a consultant to the General Accounting Office on this matter, and I want to emphasize that anything I say here is my personal opinion. I should not anticipate the report of the General Accounting Office, which is designed to answer this specific question. So I give my own opinion. I believe it is feasible to have uniform cost standards provided that the word "standards" is interpreted as being broad guides, broad statements, and not little details of how you keep the books. I am quite certain that you, sir, in advocating this, had no intention of saying that we should come out with a manual that says exactly how the contractors should keep his books, what he should put on page 20, and so on. That is not what you mean by standards, I quite sure.

Chairman PROXMIRE. That is exactly right. What we had in mind, however, was that there should be sufficient uniformity so that you could get the same kind of assurance that I understand the Internal Revenue Service, for example, gets, in insisting that the taxpayers meet certain accounting standards when they make their tax reports from corporations.

It seems to me that it shouldn't be any more difficult for the contractor to make a report to the Defense Department than to the Internal Revenue Service. The Internal Revenue Service wouldn't for a minute, and the courts wouldn't for a minute permit one taxpayer to operate on an entirely different basis that would give him a great tax advantage over another, if he does that obviously it is improper, and we take action.

Mr. ANTHONY. The Internal Revenue Service does permit a good deal of leeway in the way a taxpayer keeps his books. I think that is the sort of thing you have in mind. It sets down general standards, and it says within these standards you can keep your books any way you want. I think that is the sort of thing that is feasible, and that is the sort of thing that we should be working toward.

The writing of these standards is a very difficult job. The General Accounting Office has only to report on the question: is it or is it not feasible? If it reports that it is feasible, then comes the job of actually writing them. And this is something else again.

Chairman PROXMIRE. Would this be useful to us, in a case where you have an overhead, a large amount of overhead, a big corporation that has a great deal of private business as well as some defense business, in allocating that overhead? One of the fears that I have is that there is a perfectly normal, understandable tendency for the perfectly honest contractor to make a judgment in favor of putting his overhead, as much as he feels he possibly can justify in his own conscience, into his defense operations. And unless he has some kind of standard on allocation of overhead, there would be a tendency, of course, for him to push these costs on the Government, especially on these contracts which are cost plus one way or another, and thereby

hold down his costs in the priority area where he could compete more effectively and enjoy higher profits.

Mr. ANTHONY. Yes, the area of the allocation of overhead is one of the most important areas where standards are desirable.

Chairman PROXMIRE. In your statement you expressed doubts about fixed price contracts. Isn't it true that in the private sector, business dealings are very often by fixed price contract, even in the area of a complex and new technology such as in the aircraft industry? I have in mind that Boeing has sold its 747 to Pan American Airlines on a fixed-price basis before the aircraft was actually built? If this is true, why is a military system like the C-5A so different from the 747 in susceptibility to fixed price?

Mr. ANTHONY. I am no expert on aircraft, but it is my impression that the 747 is more like the 707, which has been built, and on which pretty good cost information is available?

Chairman PROXMIRE. More like the 707 than like C-5A?

Mr. ANTHONY. A big 707, yes, rather than a little C-5A.

Chairman PROXMIRE. That surprises me, because I thought that Boeing and Lockheed both bid on the C-5A.

Mr. ANTHONY. Yes, they did.

Chairman PROXMIRE. As you know, Lockheed got it, and the Review Board thought that Boeing had a better design. Lockheed was lower in price, \$300 million lower. But I had the impression that Boeing then went ahead with their jumbo jet, which is roughly the same size, a little smaller, but roughly the same size, roughly the same weight, roughly the same kind of capability—of course, structured to carry people instead of freight, but quite similar to the C-5A.

Mr. ANTHONY. If we take the C-5A, I think it is obvious that Lockheed would not have entered into the contract as it was entered into if they had known what the costs were going to be, because Lockheed is not going to make a reasonable profit on this contract. And that illustrates the difficulty—

Chairman PROXMIRE. How do we know they won't profit? I think that you are probably right; they say they aren't, and the Air Force says they aren't. But until we have uniform accounting standards how do we know what profit anybody is making, or until we have the subpoena power by the Comptroller General and we can go in and really make a thorough investigation, how do we know the profit or loss?

Mr. ANTHONY. You are right, we won't know it exactly. The C-5A is being built in a physically separate plant from the rest of Lockheed operations. You have the problem of allocating general corporate overhead to it, but outside of that the costs associated with that plant are pretty clean, I think.

Chairman PROXMIRE. Not only the corporate overhead, but they can pour all kinds—there is some problem in the cost of the research and development on the one hand and the production on the other, there is some contention that they push some of their research and development into production. That is one element, one problem.

Mr. ANTHONY. It is still part of the total cost that Lockheed is going to get compensated for.

Chairman PROXMIRE. There is also the question that Lockheed can get well on their commercial business, once they go through all this

with the Government they can turn around and build big air freight planes for private industry and be in a very desirable competitive position.

Mr. ANTHONY. Yes, indeed, this is possible. But I still think that had Lockheed known then what it knows today about the cost, it would not have entered into this kind of contract. And this is an illustration of the difficulty of estimating costs in this kind of a complicated weapons system.

Chairman PROXMIRE. Do either one of you gentlemen see any reason why the Federal Government should go ahead with the second run of the C-5A either the 23 planes or the additional 62 planes, if it is concluded that we don't need those planes? Is there any moral reason why we should, or any practical reason why we should that you can see? Supposing you make a decision that we only want 58 planes? As a matter of fact, I understand Air Force Secretary Brown at one point indicated that maybe that would be all right. And my analysis indicates that in terms of the cost we have one terrible time justifying more than 58 planes. But I am asking, in view of the effect on the corporations—both of you gentlemen have great business experience as well as governmental experience—do you see any reason why, we start with the 58, there is any obligation either moral or practical on the part of the Government to go ahead.

Mr. ANTHONY. I think the Government has both a moral and a legal obligation to pay for whatever costs have already been incurred on additional aircraft. Beyond that I don't think it has any obligation.

Chairman PROXMIRE. You mean to bail out Lockheed so that they don't lose anything?

Mr. ANTHONY. If Lockheed in good faith has undertaken to start additional aircraft—and remember, the process of building an aircraft takes many months—then it seems to me the Government has an obligation to pay for the costs that have been incurred for that.

Chairman PROXMIRE. I don't argue with that at all, you are absolutely right. But I am talking about, if we bought 58 planes, and they have only built five—it is true that there is a long leadtime, but it would seem to me that the additional costs of the Government wouldn't be great. There would be a very substantial loss to Lockheed, obviously. Some estimates are \$650 million.

I don't know if the corporation could sustain that kind of loss and survive. You have other Government contracts with Lockheed that are larger. But it is a big loss.

Mr. ANTHONY. Of course it is. But I don't think myself that there is a moral or legal obligation to go beyond the point that I have just described.

Mr. NIELSEN. I would agree. I think that the question is whether, in fact, you need the additional aircraft based on their current estimated costs, whether they are an effective utilization of resources in the future, that is the decision that needs to be made. And I think that decision was made in the Department of Defense. And I would hope that the Congress would support it.

Chairman PROXMIRE. Very good.

Then I take it that you gentlemen would agree with this—and perhaps I can conclude. In fixed-price defense contracts why can't the

Pentagon hold a contractor's feet to the fire so that the Government will obtain the benefits of its contractual arrangements?

Mr. ANTHONY. In fixed price defense contracts the Government should hold the contractor's feet to the fire.

Chairman PROXMIRE. You agree?

Mr. NIELSEN. I concur.

Chairman PROXMIRE. What is there about fixed price contracts awarded by the Pentagon that are so different from fixed price contracts in the business world? In those cases where, as I mentioned, technologies are almost equally complex, is there anything else besides technology that should be considered here?

Mr. ANTHONY. No, sir; I don't believe so.

Chairman PROXMIRE. You believe a fixed price contract is a good contract provided the technology will permit it?

Mr. ANTHONY. It is a good contract, provided you can estimate the costs. Yes; certainly, it is the desirable form of contracting whenever you can do it.

Chairman PROXMIRE. Gentlemen, I have some other questions I would like to ask you, not just for the record but here. But there is a rollcall on the Floor. I will be back in 10 minutes. I apologize for detaining you. But would you permit me to run and come back.

Mr. ANTHONY. We would be happy to.

Chairman PROXMIRE. The committee will stand in recess for 10 minutes.

(Short recess.)

[Testimony resumed.]

Chairman PROXMIRE. I apologize, gentlemen, for having to go over to vote. You are very patient.

I would like now to ask you gentlemen to inform me as to what the substance of DODI 7000.2 is. I understand that this document relates to project PRIME and SAIMS.

Are you familiar with this document?

Mr. ANTHONY. Yes, sir.

Chairman PROXMIRE. Will you explain it?

Mr. ANTHONY. DODI 7000.2 describes the system of the Performance Measure of Selected Acquisitions. It is the end result of about 2 years of effort within the Defense Department and in discussions with contractors. We believe it will change the whole emphasis of performance reporting. Hitherto, the general practice had been to work out a detailed control system in the Pentagon for each major weapons system, and then impose that system on the contractor and make him use it along with his own control system. The theory of DODI 7000.2 is that we will reduce tremendously the amount of paper work involved in contract performance by drawing information from the contractor's own system, rather than having a separate system. In order to make that concept work, we had to establish criteria as to what is an acceptable contractor system. It was the working out of those criteria which was the most controversial part of this effort.

Industry by no means agrees with the criteria that have finally been worked out.

Chairman PROXMIRE. Industry did work with you in developing this?

Mr. ANTHONY. They worked at great length with us in this. But we did not accept their point of view in all cases. And there is still some effort on the part of industry to get the criteria changed. I personally hope such efforts will be resisted.

Chairman PROXMIRE. What has been the reaction of the Council of Defense and Space Industries Association?

Mr. ANTHONY. The CODSIA was the group that we looked to in working out the criteria. With one major exception, they basically agreed with the criteria. The exception was that we thought it necessary to measure the costs incurred on a contract and match with it the work actually done. They did not see that as a necessary criteria, but we insisted on it anyway.

Chairman PROXMIRE. Do they accept the systematic approach incorporated into this?

Mr. ANTHONY. They are very much in favor of the general philosophy of 7000.2. And they have supported us and worked very hard with us in trying to work out differences of opinion.

Chairman PROXMIRE. Do you think it is fair to say that the Defense contractors have been responsive in their efforts to water down this instruction as it applies to direct costs?

Mr. ANTHONY. Certain contractors have tried to water this down. They have been unsuccessful, and I hope they will continue to be unsuccessful.

Chairman PROXMIRE. How in general do you appraise the role of the defense contractor in the development by DOD of better management control systems?

Mr. ANTHONY. Naturally, our points of view do not always coincide. When this happens, we get together and try to work out a solution that meets our needs and imposes a minimum amount of burden on the contractor. If there are still differences of opinion, and the Defense Department nevertheless feels that it needs the information presented in a certain way, it gets the information in that way.

Chairman PROXMIRE. Let me ask you if you can give me an answer to this generalized question. Has the influence of defense contractors encouraged the development of meaningful systems, or would you say it has on balance been a primary cause of our current predicament of having very limited Defense Department control over contractor cost and performance?

Mr. ANTHONY. By and large I would say that it has encouraged the development of better systems, both in the work—

Chairman PROXMIRE. We still have very limited control, though, don't we?

Mr. ANTHONY. We are getting there. We still do have limited control; indeed we do. But you asked have contractors by and large encouraged it. And I think that they have, both in the constructive work that industry has done in 7000.2, and in other efforts culminating in instructions for the elimination of paper work. In these efforts the defense contractors assigned some very top people to a rather massive undertaking that we undertook to cut out unneeded reports. The defense industry cooperated very, very well with that undertaking at considerable costs to themselves.

Chairman PROXMIRE. Mr. Nielsen, did you have an opportunity to work with this in this area?

Mr. NIELSEN. Yes, I did.

Chairman PROXMIRE. Would you like to comment?

Mr. NIELSEN. Yes, I would be glad to.

I would only concur with all of the statements that Dr. Anthony has made, with the exception perhaps of the contract relationship. It seems to me that there is a very difficult problem with the contractors. In describing this system, a criteria has been established which is very general. The implementation of that criteria by the contractor, however, requires a specific detailing of duties to a contractor; how specific it should be, and what kind of effort should go into it. This requires a full understanding by the Government of its own requirements in trying to explain them to a contractor. I found, in my working on it, this was a very difficult problem.

I think contractors resisted it primarily because they didn't understand the benefit of the information or weren't clear that the extra costs associated with these information systems would pay off. I felt strongly that they would. I think we worked as hard as any group in trying to get contractors to put in acceptance systems.

All I am saying is that there is a much bigger effort here than we all might tend to look for and it is going to take a lot longer than any of us would like to get the kind of information we want.

Chairman PROXMIRE. Do we have any example, any instance, any file on the study, any way that has been put into effect in any degree to determine its workability.

Mr. NIELSEN. I think the closest system—one that has been accepted by the Air Force as meeting their criteria, which is somewhat different than the DOD criteria and I think is a little more restrictive than the DOD criteria—is in use by the General Electric reentry systems division in Philadelphia. In that case the contractor uses the same management information to manage its program as they are giving to the Air Force. This does the kind of things that Dr. Anthony suggested, that is, it compares actual costs with plans both in schedule time and in the technical aspects of that program.

In my judgment they haven't reached the end of the line, however. Even though the Air Force has agreed to that system at the present, there are some improvements that they should make to get better control over costs, or to improve their ability to control costs.

Chairman PROXMIRE. I would like to ask one other question in connection with this document. And that is connected with the contractors' direct cost, the application of that direct cost, and the contractors' attitude toward it. Why did they object, and why do you feel that their objection is not well taken?

Mr. ANTHONY. Well, there are two reasons, I guess, that they object. One of them is that with respect to progress payments a contractor quite properly gets paid progress payments on the basis of articles that he buys for the contract. He is worried that the 7000.2 system, which has nothing to do with progress payments at all, might get interpreted as meaning that he would only get paid his progress payments when he puts the material on to the aircraft, or whatever it is. This worry is unfounded. This object is just a red herring.

The other objection is that this device of matching costs incurred with work done is the very best way of increasing the visibility that

you were talking about earlier. The contractor is not anxious to increase that visibility, and he therefore objects.

The proper course of action for the Defense Department is to disregard such objections.

Chairman PROXMIRE. If you were the Government's representative what would you do with the contractor's objections?

Mr. ANTHONY. I would disregard them—I have disregarded them in many meetings.

Chairman PROXMIRE. Would you concur with that, Mr. Nielson?

Mr. NIELSEN. Yes. And I think that I have. On the other hand, there is a different view as to the extent one should go in a criteria which is built on progressive or successive breakdowns of work that the contractor is going to accomplish. There is some question in my mind as to how deep one goes into that breakdown of work, and how far you go to tie in the underlying systems that a contractor uses to manage his program. We have found, I think, in each case—that in many cases—there are other systems that exist in a contractor's operation; such as a detailed manpower reporting system, that has not been tied in to the overall reporting system. How far and how much we can do to see that these systems do relate is really a very difficult question to determine. I think we have to push contractors continually to make those ties, to make them meaningful, and to make them a part of a total reporting system.

But this is quite a change.

Chairman PROXMIRE. At this point I am going to insert in the record the document to which we have referred, the CODSIA statement on cost schedule control systems criteria, and the letter accompanying it to Assistant Secretary of Defense Barry Shillito from a number of persons responsible.

(The document follows:)

ASSISTANT SECRETARY OF DEFENSE,
Washington, D.C., July 11, 1969

Memorandum: For the Assistant Secretary of Defense (Comptroller).
Subject: DoDI 7000.2, Cost/Schedule Control Systems Criteria (C/SCSC).

Enclosed are a copy of a letter from the Council of Defense and Space Industry Associations (CODSIA) dated July 1, 1969 forwarding me a paper regarding the subject matter and a copy of my letter to CODSIA.

I would appreciate your reaction to the CODSIA paper.

BARRY J. SHILLITO.

COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS,
Washington, D.C., July 1, 1969.

HON. BARRY J. SHILLITO,
*Assistant Secretary of Defense (I&L),
The Pentagon,
Washington, D.C.*

DEAR MR. SECRETARY: In response to your indication to our Task Group Chairman, Mr. A. A. Landesco, Jr. that you would appreciate background information and Industry recommendations on matters at issue with regard to Cost/Schedule Control Systems Criteria (C/SCSC), attached is a CODSIA statement on this subject.

This statement summarizes industry's understanding of the purposes of C/SCSC, a history of its interface with DOD and the comments which industry has developed on some of the key issues. It is our concern that with the passage of time and change in participants these matters may have become somewhat fragmented and hazy. It is our intent to organize and present in this paper a

single statement and accurate summary which may be useful for clarification of present status. We hope it serves this purpose for you.

If you wish to be provided additional information we would be happy to provide any clarification and supplementary data which you may desire. Mr. J. Morton Turner is the CODSIA Project Officer and contact on this case and will make any such arrangements. His number is 347-2315 here in Washington, D.C.

Very truly yours,

Joseph M. Lyle, President, National Security Industrial Association; Robert W. Barton, Western Electronic Manufacturers Association; Edwin M. Hood, President, Shipbuilders Council of America; L. H. Miller, Esq., General Counsel, National Association of Manufacturers; James G. Ellis, Manager, Defense Liaison; George E. Lawrence, Executive Vice President, Scientific Apparatus Makers Association; William H. Moore, Vice President, Electronic Industries Association; Karl G. Harr, Jr., President, Aerospace Industries Association; Kenneth M. Jackson, Chairman, Procurement Regulation Committee, National Aerospace Services.

JUNE 27, 1969.

CODSIA STATEMENT ON COST/SCHEDULE CONTROL SYSTEMS CRITERIA

In the forging and fulfillment of our national defense objectives, no other single concept has provoked as profound a change in planning and analysis techniques as the philosophy of using a systematized approach for management purposes. This change has been and is being forced by two particularly compelling needs in the current Department of Defense environment:

1. The urgent necessity for a synthesis of strategic alternatives, weapons technology, and total resources in fulfilling national defense objectives.
2. An equally urgent need for a unified information system within the Department of Defense to streamline and accelerate the process of high-level decision-making, particularly with respect to highly complex weapons systems.

As an integrated discipline for defense hardware development and acquisition, the systems concept gained its prominence in the 1950s. Its initial use, both within the DOD and industry, was directed to the coordination and management of the technical aspects of complex programs. But it was not until the early 1960s that Secretary Charles J. Hitch, then DOD Comptroller, reduced to practice his new concept of programming which was essentially the forerunner of the system approach in managing for the concept was designed to integrate top level decision-making into the three required phases of planning, programming, and budgeting for DOD systems acquisition.

One of the essential ingredients of this comprehensive systems approach is an effective means of ensuring reliable visibility, measurement, and control of cost, schedule, and technical accomplishment during the period of contract performance. The overall planning, programming and structuring of a weapons system procurement are determinant factors in making possible such reliability. In other words, establishing the phases of the procurement cycle, developing the systems requirements and attendant work breakdown structure, identifying critical items, and contracting appropriately to reflect the technical and related cost risks are primary requisites to effective project management. This project management, in the case of major systems procurement, is impossible without a cost and schedule measurement system which provides reliable and meaningful data and which supports and affords integrity to the broad scale planning, programming and budgeting of DOD.

To ensure that this highly significant element of support is available during contract performance, the DOD felt the need to establish a single set of criteria to be used by all DOD components which contractors' cost and schedule control systems should meet. These criteria have been set forth in DODI 7000.2, "Performance Measurement for Selected Acquisitions", dated December 22, 1967. As stated in this Instruction, DOD's purpose is to set forth uniform DOD requirements covering contractors' management control systems for application to selected defense contracts. It covers the use of Cost Schedule Control Systems Criteria (C/SCSC) on selected acquisitions during the engineering development,

operational systems development, and production phases of the acquisition. As written, it is intended for acceptance and application by all Military Departments.

Through DODI 7000.2, DOD is striving to encourage its contractors "to accept and install management control systems and procedures which are most effective in meeting their requirements". Contractor systems capable of satisfying the criteria are expected to provide an adequate basis for responsible decision-making by both the contractor and DOD management. In that process, the contractor's internal management control systems must provide data which (1) indicate work progress, (2) properly relate cost, schedule and technical performance, (3) are valid, timely and auditable, and (4) provide DOD managers with a practicable level of summarization.

In more specific terms, the C/SCSC is a composite of criteria and related demonstration tests which DOD will expect its contractors for major procurements to meet in their schedule and cost control management systems. The basic concept requires detailed planning of all identified work and measurement of actual performance to all levels of a work breakdown structure in accordance with MIL STD 881, both for cost and schedule compliance. Comprehensive time-phased budgeting, variance analysis, DOD constraints and controls over changes to planning and actual cost reporting are other basic elements of the system.

Industry has generally endorsed the basic objectives expressed in the DOD Instruction, although it does not agree where particular methods are prescribed. The majority of defense contractors consider that they and DOD have mutual objectives in this area and they are vitally interested in improving their cost and schedule management control wherever possible.

The requirements of the Military Departments in implementing cost and schedule control management systems have, in some instances, been more demanding because of certain problems. During the early phase of the efforts to systemize cost and schedule control management, certain Military Departments reported instances of systems control deficiencies on the part of contractors such as lack of control over work authorizations, ineffective performance measurement, unwarranted transfers of cost and/or budgets from one element of the work breakdown structure to another and inadequate accounting for material. Compositely, these situations caused sufficient concern at the Military Department level so that the systems they proposed for implementation were designed to preclude the recurrence of these deficiencies, and to meet the DOD and industry objectives of having a system capable of providing reliable and meaningful data. The Military Departments imposed constraints designed to prevent the recurrence of previously experienced problems. As a result, the prescribed control systems requirements became more specific as to the methods to be used and less compatible with requirements, for internal management.

Industry has been concerned that, because of the rigid and burdensome nature of some of these extra requirements in the systems at the Military Department level, they would not have sufficient flexibility to adapt these systems to the real and changing needs of their businesses. The complexities and detail of the Military Departments' requirements proposed from time to time to have been such that Industry has found them very difficult to implement, prohibitively costly, and potentially stifling to the point of impeding performance. Industry has felt that the more flexible management system requirements it has proposed (in large part agreed to by OSD) would discourage deficiencies wherever objective management practices were followed. Industry contends that no degree of severity in *systems* application could preclude poor management or deliberate evasions. These latter conditions must be met by means other than C/SCSC, which should and must be designed solely for management purposes and not as a policing action.

It appears to Industry that the Military Departments, in addition to supporting DOD objectives, have attempted to incorporate measures to serve their own detailed objectives. Industry objects to this approach. Industry fears have been justified by experience in systems demonstrations and audits conducted by the Military Departments. Countless thousands of hours have been expended in preparation for these reviews, hundreds of pieces of correspondence exchanged afterwards, and numerous follow-up meetings conducted over the past three years, with the result that only one system, applied to a single program and a single contract, has been "validated" to date. Program agency review team members and program managers appear to apply their own interpretation of the specifics of compliance with the criteria. This results in complex and excessive

data of questionable management value. However, if the basic objectives of the cost and schedule management system requirements are limited to those set forth by DOD in DODI 7000.2, Industry and DOD should have little difficulty in developing mutually acceptable requirements.

If it can be established that the objectives of DOD, the individual Military Departments and Industry are identical, it should be not only possible, but highly desirable to find in very short order a completely acceptable single set of criteria for universal use. The principal problem is to provide sufficient flexibility in the criteria and their implementation to permit the use of a diversity of proven techniques which can be demonstrated as complying with such criteria.

One of the salient requirements of both DOD and the Military Departments is that the cost and schedule control system used by contractors for performance measurement and reporting, must also be that system used by the contractor for his own management of the project. Industry completely supports this principle since redundant systems are costly, confusing and a management problem. It is, therefore, essential to agree on sufficiently broad criteria that are cost effective, practicable, usable as a contract management tool, and at the same time, adaptable to the individual needs and conditions of each contractor and type of work to be performed.

There is a long history of negotiations between DOD and Industry in attempting to develop such a meaningful system with sufficient flexibility to accommodate all types of business across the defense procurement spectrum.

In the summer of 1966, DOD issued its first version of the Cost and Schedule Control Systems requirements in the form of a specification. It was based on a composite of the Earned Value System and portions of the Air Force CSPCS, largely derived, in turn, from the Earned Value System. In response to DOD's request for comments the Council of Defense and Space Industry Associations (CODSIA) indicated that the proposed criteria were impracticably detailed and inflexible. Further, they would have placed ultimate management control in the Government by making all significant aspects of contractor compliance "subject to the approval of the contracting officer". CODSIA recommended that the most effective approach would be to develop meaningful criteria describing *what* the contractor's system should be capable of doing, rather than specific instructions and procedures on *how* to do it. At the same time, Industry endorsed the broad objectives of DOD and proposed a set of criteria which it considered acceptable in terms of detail and flexibility, while potentially providing for the basic DOD objectives.

As a result, Industry's desire for a broad criteria approach was endorsed by DOD without fully agreeing with Industry's proposed draft. Industry and DOD then set about negotiating mutually acceptable criteria and did, in fact, agree on a preliminary version in late 1966. Subsequently, however, DOD issued another draft of criteria now known as C/SCSC, supplemented by a group of 12 demonstration tests. After careful review, it was industry's considered view that, compositely, the effect of these criteria, supplemented by the proposed demonstration tests, was once more to place unacceptable constraints and detailed requirements on contractors in the form of singularly rigid approaches which could not and should not be uniformly applied to all contract circumstances.

In its response, dated August 4, 1967, to this latest version, CODSIA once again took issue with the inflexibility of the criteria and objected to them because they prescribed *methods* of measurement and control rather than *what* the contractor's system should be capable of doing. In addition, CODSIA offered to work with a designated DOD team, including representatives of the Military Departments and once more attempted to negotiate a set of meaningful criteria and implementing guidelines. The criteria included in DOD Instruction 7000.2, dated December 22, 1967, represent the results of that effort, but do not conform, in several major respects with the version which had been agreed to by the OSD/CODSIA Task Group. The following are specific areas of difference: the applied direct cost concept and related accounting requirements with respect to material, the "necessity" for short span work packages and requirement for a "properly related" technical performance measurement system. Discussion of each of these topics is included later in this paper.

Following the issuance of DODI 7000.2 in December of 1967, DOD designated a Task Group composed solely of Military Department personnel to draft a guideline for evaluation of contractor systems. Mutually acceptable provisions in this Guide for Performance Measurement were and remain of extreme importance to Industry because of their intended use by DOD :

1. As a factor in the source selection process.
2. As a guide for contractors to describe their Cost and Schedule Control System.
3. As a basis for qualification of the contractors' systems.

Industry worked with this Task Group of the Military Departments in an extended series of day-long meetings and explained its position on the controversial points to be covered. The draft Guide subsequently issued for comment did incorporate a few of the Industry suggestions, but did not include a number of provisions considered by Industry as essential for comprehensive application to defense contractors. Accordingly, in responding, Industry emphasized the necessity for further revision, a position which we understand was also taken by several DOD components. To our knowledge, there has been no further significant progress with respect to the publication of the Guide. It is our belief that the delay is caused by the fact that agencies within the Military Departments take issue with the Guide as both DOD and Industry believe it should be written because it does not implement the specific detailed requirements mentioned previously which in effect would greatly exceed the requirements for effective performance measurement and control.

A revision of DODI 7000.2, as yet unpublished, was discussed with the CODSIA Task Group by representatives of OSD last Fall. The Task Group believes that with very few changes, this document could be acceptable and one with which Industry felt it could reasonably comply even though in some instances without measurable or cost effective benefit to either party.

However, one of the important points with which Industry takes issue in the proposed revision to DODI 7000.2 is the statement that there will be a "guideline document issued to explain and *amplify* the criteria". Industry understands that it has always been the DOD's intent that the criteria would constitute a single overriding and limiting requirement and that the related guidelines were not to amplify or enlarge upon these criteria, but solely to explain their implementation. On the other hand, some in the Military Departments contend that the criteria should constitute a *minimum* requirement susceptible to supplementation by each of the departments to suit its particular objectives. This interpretation would defeat the objective of developing a single set of requirements for use by all Components, and supports Industry's concern that the real objectives of the Military Departments differ substantially from those of DOD and Industry. Until these differences are resolved, the revised 7000.2 and the related Guide are apparently being held in abeyance by DOD.

In the meantime, various systems are being promulgated by the different Military Departments, and varied requirements are being simultaneously included in different request for proposal. This condition is directly contrary to the intent expressed by DODI 7000.6 and 7000.7 regarding control of the proliferation of management systems and the concept of basic agreements as expressed in DODI 7000.2. Industry has already experienced great variety in cost and schedule management control system reporting requirements—in basic content, depth of detail, format and frequency. Differing requirements for variance analysis have been specified, some of which are totally unrealistic for practical management use by resulting from redundant development, maintenance and changing of systems and computer programs or from providing entire duplicate systems in some instances.

Additionally, there are specific differences relating to the DODI 7000.2 of 1967 which center around several basic issues as follows:

1. The Military Departments' position is that the work packages on any given program should be time limited on a very short span, not-to-exceed basis, and the work in process constrained to a minimum at any given time. This is apparently intended to make it difficult for contractors to transfer significant budget provisions between work packages and between cost accounts. Industry, on the other hand, is firm in its position that the work packages should not be time constrained, but should reflect natural subdivisions of the work to be performed in the way in which it can most effectively be managed. Industry fears that artificial constraints on the size of work packages will lead to the use of meaningless milestones for performance measurement, and consequently, the reliability of the entire system may be seriously undermined, and its utility as a management tool greatly impaired. The CODSIA Task Group and OSD, at one point in time, had mutually agreed upon a definition of "Work Packages" which recognized all factors which should be considered in arriving at the definition of this

term. However, paragraph 2 of DODI 7000.2 as published does not place these factors in proper perspective. The original definition set forth principles for establishing the size and duration of work packages. By the change in subparagraph "2m(5)" substituting the word "necessity" for "desirability", all other principles were effectively nullified. In addition, masses of manually controlled paper are required to comply with such a requirement resulting in additional cost for no real benefit. Such circumstances reduce the systems' *viability* for the contractor's internal management purposes. If the use of one system to satisfy both Government and Contractor program management needs is to be realized, the Military Departments must abandon the idea of arbitrarily constraining Industry's work packages to unreasonably short time span increments.

2. Some in the Military Departments support retention of and measurement against the original baseline budget (modified only for contract changes) at cost account level or lower. However, the baseline budget, with the passage of time, frequently ceases to reflect the then current work requirements as a result of more clear definition of tasks, "work around" techniques, and in-scope changes and it becomes necessary to revise the operating budget at performing levels to reflect such changes. At this point, there is no longer any purpose in retaining the original baseline budget at these low levels. There is a need, however, for a revised, meaningful, detailed operating budget to reflect the current work statement and schedule. It is agreed that there is unquestionably a need for traceability of changes at all levels as well as the retention of the original baseline budget at contract line item level. This would be entirely adequate to ensure early notification of a potential overrun and prevent improper utilization of funds budgeted for future work. In CODSIA's opinion, the proposed requirements by the Military Departments for baseline budget retention to very low levels is unnecessarily costly, cumbersome and impractical. If one system for both Government and Industry is to succeed at detail levels, it must be flexible enough to satisfy the overriding contractor requirement, that budgets issued to operating line organizations must represent a realizable goal to provide a realistic incentive for good performance.

We understand the three basic DOD objectives under the proposed revision are:

(a) to maintain the integrity of the cost measurement system for purposes of unit or lot cost determination on individual items under the contract.

(b) To ensure compatible time-phasing of the material charges and labor performance within individual work packages.

(c) To establish a system of accounting for material which assures adequate material accountability from the DOD standpoint, including variances from projected usage.

Industry has freely acknowledged that there are certain types of work under certain types of contracts for which the so-called "Applied Direct Cost" concept of accounting for material is practical. The objection is that the Instruction applies this concept universally to *all* DOD business subject to C/SCSC.

It should be emphasized that the defense business subject to C/SCSC is a *contract* business the accounting for which is entirely different from the accounting for production of "off-the-shelf" items for anticipated sales. For this reason, both DOD and Industry should be concerned that all legitimate material costs incurred for each contract be considered when developing historical or projected unit or lot costs or when measuring performance.

Application of the cost of material considered necessary, including development materials procured for schedule assurance but not used, and the excess to cover spoilage, rework, etc., is essential to obtain a true picture of the cost of performing a specific piece of work, even though some part or even all of the excess is not actually consumed, in the process of the work. The mere fact that it was considered necessary to have it on hand and available for potential use makes it misleading to develop a cost of the work performance without including it. Industry accepts the need to promptly and appropriately reflect any useful diversions of the surplus material. It should be recognized that failure to charge as applied cost all materials which, in good business practice, are necessary to assure successful performance of a contract defeats the basic purposes of deriving the true unit or lot cost and accurately measuring performance from the total of applied costs.

Industry feels very strongly that the justifiable and sound objectives for good material accountability can be achieved through other, less complex and costly

methods. The requirement for the accounting transfer of costs as material is consumed places upon defense contractors, as a minimum, an extra pricing exercise which, in the vast majority of cases, contributes nothing to effective management of materials. Industry feels that the applied cost concept as a rigid and comprehensive requirement for all systems procurement should be dropped. It is burdensome, wasteful, and is not cost effective for a significant percentage of procurements and contracts eligible under C/SCSC. Rather, the DOD should establish that contractor systems must have the capability to control and account accurately for materials, develop reliable unit costs, and accurately and effectively measure work accomplishment which includes the purchase, receipt and use of materials. The criteria should recognize a variety of approaches to achieving these objectives leaving it to the contractor to show that his approach achieves the desired results.

It should be clear that Industry does recognize theneed for (1) accurate and complete unit or lot costing in appropriate circumstances, (2) for adequate material accountability and (3) reliable measurement of work performance. It stands ready to perform to achieve these results, but not necessarily according to the applied cost concept with respect to materials.

4. As currently written, DODI 7000.2 and the related draft Guide for Performance Measurement contain requirements for a Technical Performance Measurement System (TPM). While this has not been made a condition for qualifying a contractor's system, it has been set up as a factor to be evaluated in the source selection process. Industry believes that this will not produce objective results since there are no standards against which to make an evaluation. Technical Performance Measurement (TPM), as an integrated system, is in its infancy as reflected by the joint memorandum of May 21, 1968 issued by the DDR&E and the ASKD (Comptroller). The language of DODI 7000.2 concerning TPM should be limited by the concepts expressed in this joint memorandum until sufficient experience has been gained to provide a proper foundation for a more complete criteria with a reasonable expectation of proper, uniform application. It should be deleted as a source selection evaluation factor.

Again, it appears that a significant element of the motivation for the Military Departments' position on the four specific points discussed above stems from the results of the early reviews which found some contractors deficient in certain aspects of cost and schedule control management. Apparently, the Military Departments' requirements are designed to preclude recurrence of these problems.

If we are to realize the full potential benefits of the concept of applying criteria to encourage contractors' management to accept and install management control systems and procedures which are most effective in meeting their requirements the four outstanding controversial issues discussed above must be resolved.

In view of these considerations, Industry recommends the early issuance of the DOD Instruction 7000.2 revised to reflect substantive changes requested in this letter and CODSIA letter of 15 January 1969.

There should also be a related Guide for Performance Measurement, which does not *amplify* the criteria requirements, but offers needed guidance to contractors in writing systems descriptions, and to evaluation teams in conducting their evaluations of contractors' cost and schedule management control systems. Such a guide existed nearly a year ago in draft form and the CODSIA Task Group reviewed and commented on it. With some revision, (as discussed in meetings and recorded by OASD) the CODSIA Task Group members indicated that they felt it was a potentially acceptable document.

It is CODSIA's recommendation that the condition under which the revised Instruction and Guide should be issued is that compositely they must become the *only* DOD requirement for cost and schedule management control and that any other systems existing in DOD, including those of the individual Military Departments, be phased out. This is especially important since most contractors do business with more than one Military Department, and it would be extremely difficult and impracticable, if not impossible, for them to operate their systems to satisfy the varying requirements of each procuring agency of the Departments.

In conclusion, CODSIA reaffirms its willingness to provide the services of its Task Group to work with DOD in any further effort to finalize an acceptable set of criteria and guidelines that will ensure mutual achievement of worthwhile objectives.

ASSISTANT SECRETARY OF DEFENSE,
Washington, D.C., July 11, 1969.

COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS,
Care of National Security Industrial Association, Washington, D.C.
(Attention of Mr. Robert Walsh, Executive Secretary.)

GENTLEMEN: I have received your paper regarding Cost/Schedule Control Systems Criteria (C/SCSC) forwarded with your letter of July 1, 1969. This is a well written paper. It has been very helpful to me. I am forwarding a copy of it to Mr. Robert C. Moot, Assistant Secretary of Defense (Comptroller).

When we have completed our review of your comments, one of my staff will get in touch with Mr. J. Morton Turner in the event it appears appropriate to request additional information.

Sincerely yours,

BARRY J. SHILLITO,
Assistant Secretary of Defense
(Installations and Logistics).

Mr. ANTHONY. Mr. Chairman, when you asked me about CODSIA's attitude I was talking about its attitude when I worked in the Defense Department. What you have just introduced is evidently a more recent expression of its attitude, and I am unfamiliar with it.

Chairman PROXMIRE. Mr. Anthony, in connection with this what was accomplished during your 3 year tenure in the Pentagon in the area of performance measurements of weapons systems?

Mr. ANTHONY. The publication of 7000.2 to which you have already referred is probably the major change that we have made in that area. That was December 1967. The implementation of that is still far from complete, but the groundwork has at least been laid. The program to simplify and make more meaningful the existing report structure with contractors was another major effort.

The program of getting what we call selected acquisition reports, which was started late in 1967, and which has, as I said, now been extended to 31 weapons systems by the present administration, is another example.

The program to get cost information on contracts broken down in such a way that costs can be used better to estimate what similar contracts are going to cost in the future is another such example.

I think those are the principal systems that we have introduced in the last few years in the procurement area.

Chairman PROXMIRE. Then will the current performance measurement system being applied, will it be able to tell us how much an individual weapons program is overrun or underrun on work to date?

Mr. ANTHONY. Indeed, yes.

Chairman PROXMIRE. It will be able to tell us that?

Mr. ANTHONY. Yes, indeed—within the limits of estimating that are always present in these complicated jobs, but yes, much better than ever before.

Chairman PROXMIRE. In other words, we would have known earlier than we did know about the C-5A overrun? We were informed in November of last year of the C-5A overrun. The estimate then by Mr. Fitzgerald was that the overrun was close to \$2 billion. Six months before that the Air Force informed the Appropriations Committee of the House that there was no overrun, in March at least they so informed the House. The evidence that we get now is that there were indications of overrun long before this report was made to the House. Presumably

if this were in effect that kind of a situation wouldn't have developed, we would have known well in advance.

Mr. ANTHONY. Indeed yes.

Chairman PROXMIRE. Would it be able to provide such information, for example, for the C-5A, the F-111, the main battle tank, the Cheyenne helicopter, the CVA's, Polaris/Poseidon, Minuteman II, including the Mark 12, SRAM and so forth?

Mr. ANTHONY. Although I am not familiar with the list of 31 weapons systems which are now being furnished, I think it includes those systems, or most of them.

Chairman PROXMIRE. You credit your successor, Mr. Moot, with driving hard toward seeing to it that better control systems are installed in the performance measurement area. As you may know, performance measurement was one of the subjects of this subcommittee's recommendations in our recent Report on Economics of Military Procurement.¹ I know that you were active in this area while you were in office, but can you tell me what has been done since you left the Pentagon? What exactly has Mr. Moot accomplished?

Mr. ANTHONY. He can speak to that much better than I, because I am not so close to the situation now. There is a group working under him trying to get the ideas of this new system implemented. The job of his office is primarily to get the Services, the very large procurement organizations in the Services to do this work. And that job is being intensively worked on so far as I know.

Chairman PROXMIRE. You say he is working on it?

Mr. ANTHONY. Yes.

Chairman PROXMIRE. There are no specific accomplishments?

Mr. ANTHONY. I am sorry that I can't tell you about this, but if you would like, at this point I will ask Mr. Moot to give me something to insert in the record.

Chairman PROXMIRE. Fine.

(The Department later supplied the material which follows:)

The following is a summary of significant actions that have been taken by the Honorable Robert C. Moot, Assistant Secretary of Defense (Comptroller) from August 1, 1968, to August 12, 1969. This list generally excludes projects under development and actions taken by line management or by other staff specialists with Comptroller assistance.

ACCOUNTING SYSTEMS

1. In July 1969 the Department of Defense issued guidelines and instructions requiring the recording and reporting of liabilities based upon documented transactions. This was a major step in the transition from an obligation/expense accounting system to an accrual accounting system and was part of a government-wide program. Since issuance of the instructions, DoD has begun to report accrual data to the Treasury for many appropriations and funds.

2. During the year, major efforts were devoted to continued implementation of the new budget and accounting system, generally referred to as PRIME, which has been designed to improve the management of operations. These efforts focused on accounting systems for operations and involved field assistance visits by a team composed of Comptroller, Service and GAO personnel. In February 1969 a Steering Group and several Working Groups were established to resolve problems that had been identified.

¹The Economics of Military Procurement, Report of the Subcommittee on Economy in Government of the Joint Economic Committee, U.S. Congress, May 1969.

3. As part of the implementation of the Resource Management System, a review was conducted of all items under the central management of each Military Department and the Defense Supply Agency to identify each item as either an "investment" or an "expense cost." As a result of this identification process, nearly one million items of supply were introduced for the first time to stock fund management. This should reduce inventory costs.

AUTOMATIC DATA PROCESSING

1. In September 1968, a joint review of automated logistics systems was conducted by the Assistant Secretary of Defense (Installations and Logistics) and the Assistant Secretary of Defense (Comptroller). This review certified the systems examined for continued development and implementation, with additional individual reviews to be scheduled periodically to insure that these major systems mature in accordance with approved plans. All Services and DSA are participating in these reviews.

2. An ADP Policy Committee has been formed to identify critical problems and recommend solutions. This Committee consists of the senior ADP officials from the DoD components and is chaired by the Deputy Assistant Secretary for Information, OASD (Comptroller). The Committee has been instrumental in developing a number of policies to improve economy and effectiveness in defense ADP operations. Also, through better communication and coordination, duplication of effort among the DoD components has been avoided.

3. On March 19, 1969, a memorandum was issued permitting and encouraging DoD components to competitively replace older equipment with cost-effective third generation computer equipment and to use emulation or translation to process existing programs on the new machines. This reversed a policy established in 1966 which required systems to be redesigned and reprogrammed before installation of new computers. The purpose of this change is to avoid redesign and reprogramming costs where possible.

4. On April 24, 1969, a memorandum was issued to implement changes to the Federal Property Management Regulation on ADPE. This memorandum also required OSD approval prior to the procurement of general purpose software that is not commercially available. This is to avoid duplicate development efforts.

5. On March 10, 1969, a memorandum was issued requiring DoD components to obtain additional or replacement peripheral ADPE competitively. Previous practice has been to order equipment from the manufacturer who made the basic machine. This change will give independent peripheral manufacturers a chance to bid and should reduce costs.

6. On March 17, 1969, DoD Instruction 5000.18 was issued to install standard data elements in Department of Defense automated data systems. The purpose of this program is to reduce confusion caused by different definitions. This should save time and money.

7. On March 27, 1969, DoD Instruction 5030.40 was issued to implement the Government-wide ADP sharing program. In addition, this instruction provided uniform reimbursement policies for use within DoD to encourage sharing and to maximize savings.

8. In August 1969, a contract was signed to provide all government components with the use of a model to facilitate the selection of computers which can meet requirements at the lowest costs. The contract was developed in cooperation with the General Services Administration and combined several duplicate contracts to reduce costs.

PLANNING-PROGRAMING-BUDGETING

1. A comprehensive review of the Fiscal Year 1969 budget was conducted in the summer and fall of 1968. This was done to reexamine priorities among defense programs and to assist the President in reducing Federal expenditures for Fiscal Year 1969 by \$6 billion, as required by the Revenue and Expenditure Control Act of 1968. As a result of this review, defense expenditures were reduced by \$3 billion.

2. When President Nixon took office, a preliminary review was made of the Defense budget submitted to Congress by President Johnson. This review emphasized the requirement for the various defense programs and their relative priority. The immediate result of this review, which is continuing, was that budgeted Fiscal Year 1970 expenditures were revised downward by \$1.1 billion.

MANAGEMENT INFORMATION AND CONTROL SYSTEMS

1. In October 1968 the first Management Systems Control List was published. The purpose of this list is to prevent proliferation of reporting requirements imposed on DoD contractors, to facilitate uniformity, and to insure that information received from contractors is useful to DoD managers.

2. On January 14, 1969, DoD Instruction 5000.17 was issued prescribing a standard methodology for addressing all organizational entities within the Department of Defense as well as all external organizations with which the DoD has contact. This was to reduce the confusion resulting from several hundred different addressing systems.

3. On February 26, 1969, a revised DoD Instruction 7041.3 was issued requiring DoD components to use economic analysis in their investment studies. The analytical technique requires that full costs and the time value of money be considered when deciding between alternative investments. Properly applied, it should enhance the productivity of DoD investments.

4. On July 8-11, 1969, the Comptroller sponsored a Financial Management Symposium which was attended by representatives of 23 different schools in the Army, Navy, and Air Force as well as the Civil Service Commission. The purpose of the Symposium was to familiarize financial management faculty with instruction and application of the latest financial management techniques, particularly economic analysis. This effort should have widespread impact as students from these schools move into positions of responsibility where they can use their training to reach more economic decisions.

5. On May 12, 1969, the Comptroller initiated a joint project with the other Assistant Secretaries of Defense designed to inventory all information flows to OSD from the DoD components as an initial step toward streamlining the improving management information. By June 13, the initial inventory was completed and forwarded to each ASD for review with the guidance that information flows to OSD should be limited to information comparing actual progress against program goals and objectives and that reports not meeting this criterion should be eliminated. Although the review has not been completed, a significant number of reports have been cancelled, resulting in a sizeable reduction in paperwork processing both at the OSD and DoD component levels.

6. During the past year, the Operations Subsystem to the Five Year Defense Program was installed. The purpose of this system is to provide managers in the Services and in the Office of the Secretary of Defense with reports of progress against plans in the Operation and Maintenance and Military Personnel appropriations. This should improve the utilization of people and dollars.

7. Comptroller personnel participated in an OSD/Service working group which reviewed the Five Year Defense Program decision-making process. This review produced several changes which should improve future operations.

WEAPON SYSTEM ACQUISITION

1. Since April 1969 Comptroller personnel have been working with members of the Senate Armed Services Committee staff and the General Accounting Office to develop an information system to keep Congress apprised of the current status of selected major weapon systems being acquired by the Department of Defense. This work resulted in the modification of the DoD's Selected Acquisition Reporting system and the extension of that system from eight to fifty-three weapon systems. The purpose of this effort is to improve the information available to Congressional and DoD leaders for funding and managing these very expensive and complex systems.

2. During the past year, Comptroller personnel have worked with the Services to apply the requirements of DoD Instruction 7000.2, subject: "Performance Measurement for Selected Acquisitions" to eleven weapon systems. This instruction requires that contractor management systems meet DoD criteria. This not only insures that contractors are using effective management control systems, but also improves the performance measurement data received by DoD since it is supplied by the contractor's own system. These procedures also consolidate multiple control systems.

3. During the past year, there has been considerable dialogue between the Comptroller's office and industry on the meaning and implementation of the policies in DoD Instruction 7000.2. In July 1969 the Air Force published a Performance Measurement Guide covering the application of the uniform DoD

criteria to selected Air Force contracts. Similar guides are under development in the Army and Navy.

4. During the year, Comptroller personnel worked with the Services to begin collecting comparable cost data for 15 weapon systems. This is to provide a data base for use in estimating costs of similar weapon systems in the future.

OTHER

1. On August 20, 1969, the Post Office Department announced that effective September 15, 1969, military personnel and their dependents overseas may send money orders to the United States from combat areas without paying a fee and from all other overseas areas by paying a reduced flat rate of 15% per money order. This announcement was the result of a major study by personnel in the Post Office in concert with ASD (Comptroller). This action is in the public and national interest in that it encourages Service personnel to increase their savings and to send their dollars to the United States.

2. The funding, accounting and recoupment instructions and reporting procedures covering NATO Infrastructure Programs were re-evaluated and improved to clarify and more precisely assign responsibilities of the military departments for managing these programs. Under the revised DoD instructions, automatic data processing techniques will be used to improve management of NATO infrastructure Programs prefunded by the U.S., and to accelerate recoupments thereof from host governments.

Chairman PROXMIRE. Are either one of you gentlemen familiar with the submersible rescue vehicle? This was a vehicle which was designed to provide rescue at sea when a submarine was in trouble. As I understand it, that is the only mission I have heard for it. I understand in the last 40 years there has been only one occasion in which it could be used. It was to cost \$36 million for 12 units, and the report that we got was that they have now cut it down to six units, and the cost would be not \$36 million, but \$480 million. In other words, the per unit cost has escalated from \$3 million to \$80 million. Mr. Shillito indicated when he testified before us that roughly that was the area of escalation, but he said that no longer is its purpose so limited—or I should say that it is not the same kind of vehicle that was originally designed.

Are you familiar with that? Either one of you?

Mr. ANTHONY. You have just described about all that I know about it. What you have described is my understanding of the situation, but I am afraid I can't say anything more.

Chairman PROXMIRE. It is astonishing, we have in this bill that is before us now \$10 million for this, authorization, and there will be more than \$30 million for this vehicle in the appropriation bill this year. And we have this colossal cost and no explanation at all, and there is nothing in the record that we can find anywhere.

Are you familiar with it, Mr. Nielsen?

Mr. NIELSEN. I am familiar only with the situation as you have just described it.

I would like to comment, however. I think one of our problems is with the term "overrun." This is not only in its broad use but certainly within the Department of Defense. I don't believe there has ever been any agreement as to what the term means. I think we could help ourselves if we could agree within the Department of Defense first of all on the base line we are measuring and how we would measure overrun. Many of these so-called overruns are really the result of contract changes where there is an actual change in the program which one might more appropriately describe as cost growth.

Now, somebody made the decision, perhaps, to change the weapons capability or something else. In my judgment that is not overrun. But we have confused—and this is true within the Department of Defense in my judgment—confused what is overrun and what are legitimate cost changes.

Chairman PROXMIRE. In a lot of these programs people have had chances time and time again before this committee, the Armed Services Committees of the House and Senate, and other committees, and they haven't been able to justify this on the basis of changes. There have been a lot of changes, 8,000 changes, I understand.

Mr. NIELSEN. That is correct.

Chairman PROXMIRE. And other systems have a great many changes. Some of those changes, as I understand it, reduce the cost, and some increase the costs.

Mr. NIELSEN. That is right.

Chairman PROXMIRE. One of the difficulties is that we don't keep track, we don't have a record. Even a fairly simple minded home-builder, you know buyer, that has somebody build a home for them, when he tells the contractor to make a change, will insist that the contractor indicate what the cost is. And of course the contractor, if he has any brains is going to tell him, because he knows he is going to have trouble collecting it, if all of a sudden a \$20,000 house costs \$5,000 or \$10,000 more. This kind of rudimentary simple minded prudence just doesn't seem to be exercised by the Defense Department. They don't keep track of these changes.

It seems to me that they ought to know exactly what they cost each time, and they ought to be able to justify this in detail and follow up on this and indicate precisely how much of the increases in cost were accountable for by changes and how much were not, and whether there has been any standard deterioration or standard improvement based on changes.

We don't have that, though.

Mr. NIELSEN. I would say substantial efforts are underway to try and make those kind of distinctions in our reporting systems.

One of the standard Air Force reports that was instituted, and is only on two or three programs—and we have never had it on the C-5A's as an example—is the SHAF-225 cost performance reports. In this report there is a breakdown between contractor changes and overrun. Now, with that report being completed, including the changes, we clearly identify overrun and change elements in cost.

Efforts are underway; what it takes is an educational program to our program managers and to the contractors that we require this kind of information.

Chairman PROXMIRE. We have to be very rigorous and careful about how much they allot—for example, in some of these programs they just loosely say that so much is because of inflation. And there is a great deal of disagreement, difference of opinion.

In the case of the C-5A there was one estimate of \$200 million inflation, and one of \$500 million. These are sincere people, but the figures are so disparate that they are not much help to Congress in attempting to determine the reasons for the increase in that case.

Mr. ANTHONY. Mr. Chairman, when you were asking about the controversial parts of 7000.2, I forgot until you mentioned this that there

is another controversial part. In the 7000.2 system we do require what is called a baseline estimate, and then a current estimate, and the difference between those two represents changes. There are a lot of people who don't think the system should always keep track of the baseline.

But we intend always to do that, and to have in the record the figure we started out with when we made the decision to procure this weapons system, that figure that the decision was based on. We intend to keep track of that for analysis of the contract.

And that is controversial.

Chairman PROXMIRE. Very good.

Mr. Nielsen, you indicated that the Air Force began its performance measure system 4 years ago. What was accomplished during your tenure in this area?

Mr. NIELSEN. Let me go back and say what was accomplished a little bit prior to my coming into this job. The effort was really begun by my predecessor, Dr. Marks, with Mr. Fox, who is now the Assistant Secretary of the Army for installations and logistics. This effort did begin by the first drafting of the criteria that is now incorporated in 7000.2. I might say that the criteria in 7000.2 is somewhat different than the original Air Force criteria. In addition, there have been substantial difficulties with and further revisions of the Air Force criteria.

But, over time, the Air Force criteria has been placed on many major contracts.

When I arrived in early January 1968 my first act was to go out and meet with the people on the Minuteman program. During 1968 we did place on each major contract for the Minuteman program the Air Force version of the criteria.

We then conducted over the period of a year a number of evaluations of contractor systems. In each case the contractor's systems failed.

We went back and conducted subsequent evaluations, and; in one case, the General Electric reentry systems on Minuteman, they had installed a system which the Air Force felt met its criteria.

We have also attempted to get on contract the performance reporting requirements which can give us monthly and quarterly information on the status of these programs. We vigorously pursued that effort.

I might say, however, that all of this requires the negotiation of contract changes, in that these requirements become contractual obligations of the contractor. So we have to get our procurement people on board, and believing that this system is going to help them manage the program better.

In my judgment, if there was anything we did during 1968, it was to convince the procurement manager that he needed this information, and that he should be on board with us. But specifically I would say the GE system is probably the first case where a contractor's systems moved forward in meeting our requirements. We certainly tried to get much better information about our demands and requirements.

Chairman PROXMIRE. Mr. Fitzgerald testified in June that the financial management secretary at one time reviewed contractor progress in this area, but that this responsibility has been transferred to the military. Is this true?

And if so do you know why such a transfer of authority from the civilian to the military occurred?

Mr. NIELSEN. I would disagree with Mr. Fitzgerald. I don't feel that one can transfer his responsibility. What I did was delegate the authority to approve the contractor system on the General Electric re-entry system. In the past the actual authority to approve had not been clearly established. What I said was that the Air Force Systems Command headed by General Ferguson at that time should have that authority.

Chairman PROXMIRE. You say in the past it hasn't been clear?

Mr. NIELSEN. That is correct.

Chairman PROXMIRE. In the past it has been sufficiently ambiguous at any rate so that the civilian authority, Mr. Fitzgerald, or someone in the Secretary's office had something to say about it before the decision was made, or had a voice in it.

Mr. NIELSEN. That is right.

Chairman PROXMIRE. It appears that you transferred that to the general?

Mr. NIELSEN. In the past also there had never been a recommendation to approve any contractor's system by the Air Force Systems Command. So the issue had never really been presented.

Chairman PROXMIRE. Why did you resolve that the way you did and provide that the military would do it?

Mr. NIELSEN. I think that the systems command had the capability within that organization to make that decision.

I might say that I also felt that we had a much bigger job to do in explaining our requirements and putting out policy and guidance as to what we required so that we fully agreed with the systems command in each of these cases.

Chairman PROXMIRE. First, Mr. Nielsen and Mr. Anthony, what was your relationship to your military counterparts in the Air Force?

Mr. NIELSEN. The comptroller of the Air Force, now General Crow, and prior to that time, General Milton, reported directly to the assistant secretary for financial management. So in that sense—of course—the assistant secretary for financial management has the unique responsibility among assistant secretaries in that there is a direct relationship with a military officer.

Chairman PROXMIRE. Could you have overruled the Chief of Staff on financial questions?

Mr. NIELSEN. No. I could overrule the comptroller of the Air Force if I wanted to.

Chairman PROXMIRE. You could?

Mr. NIELSEN. I could, yes.

Chairman PROXMIRE. Did you ever?

Mr. NIELSEN. I would say in certain cases with respect to the implementation of a number of these systems.

Chairman PROXMIRE. And I guess you don't have—maybe you do have a military counterpart.

Mr. ANTHONY. No, I did not. The Joint Chiefs of Staff, which is the closest counterpart to the Office of the Secretary, does not have a controller function.

Chairman PROXMIRE. Is there any area in which you have—could have overruled or would have overruled the Chief of Staff or the Chiefs of Staff on financial questions?

Mr. ANTHONY. As a staff man, as a controller, I overrule nobody. I make recommendations to the Secretary, and he makes the decisions.

Chairman PROXMIRE. And he could overrule it?

Mr. ANTHONY. I made him such recommendations, yes.

Chairman PROXMIRE. And he would act on those recommendations sometimes favorably?

Mr. ANTHONY. Yes, indeed.

Chairman PROXMIRE. What I am trying to get at is just what control a civilian controller or head of financial management has within a military environment, if you would discuss that briefly.

Mr. ANTHONY. In the first place, it is important, I think, that the comptroller be viewed as a staff man in any organization, either in a company or in the Government. He makes recommendations to the boss, in my case the Secretary of Defense. In the Office of the Secretary of Defense, I don't think there is the slightest problem of being worried about military overruling civilians, or anything of that kind. My organization makes recommendations to me, and I make them to the Secretary, calling the shots as we saw them.

Chairman PROXMIRE. Everything depends, of course, on the personality and the attitude of the Secretary. If he is the Secretary who puts more emphasis on military advice and has a greater respect or regard or concern about the military advice than he has about the advice in this area from his comptroller, then very often he will overrule his comptroller?

Mr. ANTHONY. Certainly.

Chairman PROXMIRE. And the contrary is the case.

Mr. ANTHONY. Even there I don't think it is as much a question of military versus civilian as it is the particular personalities involved. Whose opinion does he respect?

Chairman PROXMIRE. Has the comptroller in DOD or the Assistant Secretary for Financial Management of the Air Force ever actually terminated the expenditure of funds on a program, for example, a weapons system, because of cost growth, poor performance or any other reason?

I take it, Mr. Anthony, that as far as you are concerned you wouldn't terminate, you would recommend termination to the Secretary?

Mr. ANTHONY. Yes.

Chairman PROXMIRE. So the question as far as you are concerned would be, have you ever recommended termination to the Secretary, and has he ever acted on it to terminate a program against the wishes of the military?

Mr. ANTHONY. Many programs have been terminated as a result of recommendations of various people in the Office of the Secretary of Defense. Indeed, we publish a list of those each year to the Appropriations Committees. Whether I took the initiative in a particular one, I can't call instances to mind. But yes; they have been terminated.

Chairman PROXMIRE. But you can't give us any specific examples of where this was done?

While you are thinking about it, let me ask Mr. Nielsen.

Mr. NIELSEN. I can't give you any specific examples.

Chairman PROXMIRE. Have you ever terminated expenditures? Answer the general question first, without reference, then, to specific cases.

Mr. NIELSEN. No.

Chairman PROXMIRE. You have not. Have you recommended to the Secretary of the Air Force?

Mr. NIELSEN. I can't recall a specific recommendation to terminate a program.

Chairman PROXMIRE. And you were in this office for how long?

Mr. NIELSEN. One year—a year and a half.

Chairman PROXMIRE. A year and a half?

Mr. NIELSEN. Yes, sir.

Chairman PROXMIRE. Isn't this an evidence of a lack of civilian control or not? In a year and a half a lot of crucial decisions were made.

Mr. NIELSEN. And I think a number of programs were terminated. Whether we specifically recommended them as opposed to their coming through from the field or how they were terminated I couldn't say. But I can't remember where I specifically said, let's terminate this program as opposed to the military view, I can't recall a single one.

Chairman PROXMIRE. Mr. Anthony said there were cases, he can't remember the precise example, but there were cases where he did play a part. But your answer is that there were no cases in the year and a half you were there where you recommended termination?

Mr. NIELSEN. That is correct.

Mr. ANTHONY. As an indication of the magnitude of what you are getting at, in 1968 we had a project called 683 in which we reduced expenditures of the Department of Defense by some \$3 billion. The initiative for that project came from my office. The \$3 billion consisted of hundreds of different actions.

Chairman PROXMIRE. Say that again, please?

Mr. ANTHONY. The \$3 billion by which we did cut expenditures in fiscal year 1968 is the sum of hundreds of different actions. My organization took the initiative in many of them. Indeed, I could give you for the record a list of actions adding up to that \$3 billion if you would like.

Chairman PROXMIRE. Give us some examples from that, please.

Mr. ANTHONY. Certainly.

(The following was subsequently supplied:)

Project 683 was an effort to reduce expenditures in FY 1968 by \$3 billion in order to offset additional costs of Southeast Asia activities arising from additional deployments and other factors. In order to reduce expenditures in FY 1968 by \$3 billion, it was necessary to reduce obligation authority by some \$6 billion because of the lag between obligations and expenditures.

As a further indication of program changes made by the Office of the Secretary of Defense, the following is a summary of the amounts (in millions of dollars) by which the Service budget requests for FY 1969 were reduced in the budget review process:

<i>Component</i>	<i>Amount of reduction</i>
Department of the Army-----	\$6,306
Department of the Navy-----	7,168
Department of the Air Force-----	7,393
Defense agencies-----	774
Civil defense-----	82
Military assistance-----	90
Total reductions-----	21,813

Examples of program reduction are given below. Amounts are reductions in obligation authority below the amounts shown in the President's Budget for fiscal year 1968:

	<i>Obligations (million)</i>
1. Reduction of aircraft procurement (33 F-4J's; 22 RF-4Cs, 50 A-37's, 25 C-130E's)-----	\$190
2. Stretch out A-7 procurement-----	104
3. Stretch out FB-111 procurement-----	127
4. Stretch out F-111A procurement-----	148
5. Deferral of aircraft modernization-----	176
6. Stretch out Minuteman III program-----	118
7. Deletion of 6 destroyer escorts-----	156
8. Deferral of 1 SSBN conversion-----	77
9. Reduction in noncombat vehicles-----	250
10. Stretch out various electronics programs-----	127
11. Reduction of R.D.T. & E. programs-----	600
Reduction of non-Southwest Asia operating costs:	
12. Army -----	645
13. Navy -----	200
14. Marine Corps-----	61
15. Air Force-----	288
16. Defense Agencies-----	6

Chairman PROXMIRE. As I understand it, you make the cuts in specific areas, you don't simply say, now we have to cut \$3 billion from the military and ask for their recommendations and follow their recommendations, you say, we are going to cut this and cut that—you recommend to the Secretary, and the Secretary says, we are going to cut in these specific areas. And that is what you did, is that right.

Mr. ANTHONY. We negotiate. The Secretary starts out and says—Chairman PROXMIRE. He negotiates with the Joint Chiefs?

Mr. ANTHONY. The Secretary starts off by saying: We are going to cut \$3 billion, and here is our list of what we think are the least harmful places to cut.

The Services come back and say: Some of these we accept, but in some of these areas we think would be very dangerous to cut.

Then we say: All right, you give us a proposal, then, that is less dangerous, but we still want the \$3 billion.

That is the kind of negotiation that goes on in such an exercise. It is a very painful process.

Chairman PROXMIRE. Tell me, if you were a Member of the Senate, how would you feel about an amendment which would provide for, say, a 5 percent or a 3 percent or 4 percent, some limited cut like that, in the procurement by the armed forces as compared with a specific deletion of a weapons system or reduction of a weapons system, which would you think would be the more responsible and the more desirable?

Mr. ANTHONY. Those two adjectives are opposites. The more responsible way is to exercise your judgment about specific programs. However, time is so terribly crucial in an exercise of this kind that often you do not just have the time to find the least painful way of cutting.

And in the absence of time, if it is the will of the Congress that a cut shall be made, perhaps the only way to do it is to make a blanket cut.

Chairman PROXMIRE. I think that is an excellent answer. It is very difficult for us here, you know. You look at the procurement bill, it is 5 pages, \$20 billion, in other words, \$4 billion a page, and there are almost no line items at all. And it took us days to find the submersible rescue vehicle—\$10 million for it. You can bury almost anything in it. It is very hard for us to go through this, especially if we are not on the committee, but even for those who are on the committee, with all the other things that we are doing, and be able to make a cut in a way that isn't dangerous or isn't likely to be unfortunate. At the same time, if you make the cut, then it is necessary for the Secretary and the Joint Chiefs and so forth to get together and very carefully assess where they think the least damage will be done in the reduction?

Mr. ANTHONY. This is correct. And you are, I think, aware of the fact that my organization had 50 highly competent people working several months along with about 50 people from the Bureau of the Budget doing the same kind of analysis on the document to which you are referring. The amount of resources that you have is vastly different from the amount of resources that we have on this same job.

Chairman PROXMIRE. They surely are.

Now, I would like to ask—I just have a couple of more questions—Mr. Anthony, your comments about overhead costs are somewhat disturbing. You say you can't support it with adequate data, but your impression is that they are higher than they ought to be. And I wonder who in the Defense Department or anywhere else could supply the committee with the adequate data on this point. Does the Comptroller have access to information which could document the problem? When you were Comptroller did you look at this problem and attempt to obtain information about it?

Mr. ANTHONY. Yes. None of the suggestions that I have made today is new. I started an effort a couple of years ago which essentially was modeled on a program by the American Management Association called group 10. In this program AMA attempted to collect the costs of performing overhead functions in a cross section of American industry.

It is very difficult because of all the problems of definition to which you have already referred. But I think we should make such an effort. We could collect the typical costs of performance of an accounting department, say, from contractors, and then we could compare those costs for a specific contractor against the averages, and we could draw some conclusions as to whether costs were out of line. But we just cannot do that today because we do not have the raw material.

Chairman PROXMIRE. I would like to ask you now, finally, to compare the financial responsibilities of the comptroller in a typical business organization, and what controls over the expenditures of money or the flow of funds that a comptroller has in a business organization, as compared with a comptroller in the Defense Department, or the functions of the Assistant Secretary, Financial Management, in the Air Force. I would like to know what the similarities and differences are from each of you gentlemen?

Mr. ANTHONY. By directive 7000.1 Secretary McNamara gave Comptroller the responsibility for the collection and analysis of all recurring quantitative information in the Department of Defense. This is

really exactly comparable to the modern controllership function in a company, which is a fairly recent development, actually. This suggests that the function goes way beyond the keeping of books. Indeed, in the Office of Secretary of Defense we don't keep the books; they are kept elsewhere. I think that the Comptroller functions, the responsibility set forth in 7000.1, is comparable to the modern controllership function in industry.

Chairman PROXMIRE. Let me ask in that connection, what does the Comptroller in the Department of Defense control?

Mr. ANTHONY. He doesn't control anything. The word controller is a misnomer, and also has been. The controller operates the system by means of which higher management exercises control. The controller should never control.

Chairman PROXMIRE. What does his recommendations control, then?

Mr. ANTHONY. Everything having to do with quantitative matters, everything that can be reduced to quantitative terms.

Chairman PROXMIRE. That is everything.

Mr. ANTHONY. That is a very broad statement, but it is true. In other words, it is much more than merely keeping the books.

Chairman PROXMIRE. Yes, it goes right to the heart of your substantive program.

Mr. ANTHONY. Yes, indeed. But this is the big difference in American business between the modern controller and the former chief accountant, whom we called the "green eyeshade man," who did nothing but keep books.

Chairman PROXMIRE. Would you have any voice at all, say, in the basic strategy, the strategy that we would be prepared to fight two and a half wars or two plus wars at the same time, a war in Europe and a brush fire in Asia or somewhere else, which I understand is the basis for our military commitments?

This is something Congress is now beginning to discuss, and we are going to question it seriously. And many Members of Congress, hawks, doves, what not, feel that we should not have that kind of an assumption, it is no longer realistic or appropriate. But was this ever discussed by you, did you ever have a voice in whether this was a wise assumption, or whether it ought to be questioned?

Mr. ANTHONY. First, the way the Defense Department is currently organized, it is the Office of Systems Analysis which, although formerly part of mine, is now coordinated with mine, which has the primary responsibility in such matters. I would indeed have a voice in any paper that came along to the Secretary on this, because it involves financial resources, and anything involving money I can make a comment on. So the answer is, if such a document came along, the answer would be yes. But the particular policy to which you refer I don't think was analyzed in any documents during the time I was there.

Chairman PROXMIRE. I think you are absolutely right, that is a very honest answer. But I think that is one of the most astonishing and remarkable aspects of this Government. Here we are spending this fantastic amount, and we don't even spend time with our best brains and our best people and most competent people to analyze what the whole assumption is based on. It makes a terrific difference in whether we have, for instance, 15 aircraft carriers, whether we

need them, or whether we have troops stationed all over the world, or whether we have more than 400 bases and more than 2,000 installations. This goes right to the heart of whether we have an \$80 billion budget or a \$60 billion budget.

But the question is never asked or debated or discussed. Some of the magazines talk about it. Once in a while the Senate will refer to it on the floor. But this fundamental and basic question is right at the heart of our whole military budget.

Mr. ANTHONY. Indeed it is.

Chairman PROXMIRE. It just hasn't been discussed.

Mr. ANTHONY. I think that the statement as you described it was not discussed in those terms while I was there. Many aspects of it, of course, come up all the time. When you are analyzing, say, a request for new carriers there is bound to be a figure in such an analysis.

Chairman PROXMIRE. Will you comment, Mr. Nielsen?

Mr. NIELSEN. I will make just one comment on the differences that I find as to financial management in the Air Force as opposed to business.

I think it is really the question of environment. The procurement business is so big within the Department of Defense, and there isn't a similar all-encompassing function within industry. Within industry you have a sales organization which demands a different kind of relationship with the comptroller. So in my judgment, the comptroller is really just beginning to come of age in the Department of Defense. He is coming of age against a very strong established organization with long rules of understanding in the contract business.

Many of the things that Dr. Anthony introduced, and I pursued, have to be incorporated into the ASPR regulations—this was very frustrating to me—the time required to do these things one just doesn't find in business.

Chairman PROXMIRE. Well, gentlemen, thank you very much.

This has been a very helpful and informative morning. You have both done a marvelous job, I think, in responding to questions as well as making fine statements. I most deeply appreciate your attendance.

The committee will stand in recess until tomorrow morning at 9:30, when we will reconvene in the auditorium of the New Senate Office Building.

(Whereupon, at 12:35 p.m., the subcommittee was adjourned, to reconvene at 9:30 a.m., Wednesday, August 13, 1969.)

ECONOMIC ANALYSIS AND THE EFFICIENCY OF GOVERNMENT

TUESDAY, SEPTEMBER 16, 1969

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON ECONOMY IN GOVERNMENT
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Subcommittee on Economy in Government met at 10 a.m., pursuant to call, in room S-407, the Capitol, Hon. William Proxmire (chairman of the subcommittee) presiding.

Present: Senator Proxmire; and Representatives Conable and Brown.

Also present: John R. Stark, executive director; Robert H. Haveman and Richard F. Kaufman, economists; and George D. Krumbhaar, minority economist.

Chairman PROXMIRE. The subcommittee will come to order.

This morning the Subcommittee on Economy in Government resumes its hearings into what we can do to provide a more efficient operation of our economy, with particular reference to Federal Government activity and Federal Government influence.

We have had extensive hearings on the military budget, which all of us know has a profound effect on the economy, and I think those hearings were useful and productive to us. This morning we start in an area which is especially vital and important.

I think it has been seriously neglected. This is especially true of the Federal Communications Commission, which has a very, very substantial influence and effect on the national economy.

After all, it does regulate the biggest corporation in America. But even more important than that, it regulates communications which, in turn, have a serious effect on the economy, as well as on our society.

We are concerned with a number of things with regard to this, particularly with the degree and competence of economic analysis by the Federal Communications Commission, and also by the Treasury Department, because we recognize the very serious influence that our tax policy has on this economy of ours.

While this has been referred to often, it hasn't been as directly and as explicitly analyzed as it should be. This morning we have two of the most distinguished governmental servants that we have had or have. I hope we can begin to make some progress.

Mr. Nicholas Johnson was appointed by President Johnson for a 7-year term as FCC Commissioner beginning July 1, 1966. Prior to that, he served for 2 years as Maritime Administrator. He is a Phi Beta Kappa graduate of the University of Texas, and honors graduate of that university's law school in 1958.

Before accepting the appointment by the President as Maritime Administrator on February 19, 1964, Nicholas Johnson had been associate member of the Washington law firm of Covington & Burling since 1963; a member of the law faculty of the University of California at Berkeley; and law clerk to Associate Justice Hugo L. Black of the U.S. Supreme Court in 1959 and 1960.

He is a member of the American Bar Association, the Federal Bar Association, and the Texas Bar Association, and lately has been in the limelight and contributing very greatly to badly needed discourse over communications media, especially television.

Many Americans saw Mr. Johnson on Sunday when he appeared on *Face the Nation*. This was one of the most interesting and significant programs that I have seen in a long time. Whatever criticism Mr. Johnson has of television, you would have to give an "A" to *Face the Nation*, at least, in providing critics as well as supporters of TV on that particular day.

Mr. Johnson, won't you come forward? We will be delighted to hear your statement.

STATEMENT OF COMMISSIONER NICHOLAS JOHNSON OF THE FEDERAL COMMUNICATIONS COMMISSION

Mr. JOHNSON. Thank you very much, Mr. Chairman, for those very nice introductory remarks.

I have a prepared statement here which, with your indulgence, I will now present and then take whatever questions you may have.

I am pleased to be able to respond to your invitation to testify on what I agree is a most important subject, one that has most often been overlooked rather than dealt with adequately. I think you are to be commended for taking this overall look at the impact of Government upon our economy, which necessarily does include in a very significant way the impact of the regulatory commissions in their decisions.

I should make clear at the outset that I am appearing as an individual commissioner, lest there be any question about that.

Chairman PROXMIRE. You usually do.

Mr. JOHNSON. Yes. But I wanted expressly to make clear on this occasion that I am not appearing as a representative of the FCC, lest there be anyone who might be confused on that score.

During the administrations of Presidents Kennedy and Johnson there was a greatly increased use of the tools of economic analysis in the determination of Government programs. Program evaluation and the planning-programming-budgeting system, often called PPBS, rely heavily on economic techniques for the specification of alternatives for decisionmakers—alternatives in programs, expenditure levels, and the long-range effects of Government decisions.

Such techniques can be complex, their use may occasionally lead us astray, but it also seems clear these efforts at rational analysis have produced a general improvement in the decisionmaking process of Government.

I think it very commendable that you would want to look closely at the performance of regulatory agencies in these hearings. It is an inquiry that might easily have been overlooked. PPBS and economic

analysis have typically been applied when there are significant Government expenditures to be made—the buying of weapons systems, the expenditures of subsidies, or the encouragement of research.

Regulatory agencies have typically been ignored in this context. They are low-budget operations, and this fact understandably tends to mask their importance to the Bureau of the Budget and the Congress. The FCC's \$20 million annual appropriation is roughly one one-hundredth of 1 percent of the Federal budget—the cost of operating the Defense Department for about 2 hours, on a 24-hour-a-day, 365-day-a-year schedule.

As you have anticipated, and I shall explain, however, a regulatory commission's budget is not a very useful measure of its impact upon the national economy and lives of our people.

The Federal Communications Commission is a resource managing and planning agency—or ought to be. It functions in what I will treat today as three major areas:

(1) It manages the use of a publicly owned resource—the radio spectrum—used by private interests.

(2) It regulates in detail the industrial organization and functioning of the broadcasting industry.

(3) It regulates, as common carriers or public utilities, the interstate telephone system, and the international communications industry.

Each of these three prime regulatory responsibilities overlaps. Broadcasters and communications common carriers are both significant users of radio spectrum; the rates charged by common carrier for network interconnection affect the industrial organization and Commission goals for the broadcast industry; new technologies in the broadcast and common carrier industries affect the demand for the radio spectrum.

The magnitude of these regulatory responsibilities is easily illustrated. The use of the radio spectrum by private interests is estimated to add \$20 billion to the GNP; the broadcasting industry grosses \$3 billion annually; and the Commission is presently—indeed this very morning—considering interstate telephone rates that could have a \$500 million effect on user rates paid for interstate service alone, not to mention the impact upon State regulatory commissions in their ratesetting procedures.

Thus, this little \$20 million agency has a profound effect on the functioning of our entire society: The efficient use of a valuable natural resource, the quality and cost of our telephone network, and the ability of broadcasters to provide the information crucial to self-government by the people.

A Commission failure to manage the radio spectrum efficiently can seriously affect economic development and lead to resource misallocations throughout the economy; inadequate utility regulation of the telephone companies could lead to rates that are too high and impair the use of communications by users; the failure to assert public interest control over the broadcast industry may result in serious imbalances of power throughout the society or in particular communities where media concentrations can threaten the democratic processes.

To illustrate, I have chosen three case studies: Management of the radio spectrum; concentration problems in broadcasting; and new telephone technology.

Let me first mention a general problem that pervades much of my subsequent discussion. One would think that an agency whose planning responsibilities are so great would make a substantial commitment of time and resources to research and policy planning. Such is not the case. There is no central policy planning unit in the Commission's organization.

In the almost 3½ years I have been on the Commission, I have repeatedly urged, with only limited success, that such a unit be created. There are now plans to establish a very small staff. But the time when the Commission can truly be said to possess an "institutional cerebral cortex" is, I am afraid, still far off.

In many ways, the establishment of the Communications Policy Task Force by President Johnson in August 1967 was an implicit criticism of the Commission's inability to do policy planning.

In part, this aversion to the policy planning is a function of the Commission's conception of self. The Commission tends to think of itself as a court, reacting to those matters that are placed before it only in terms of the information from interested parties pursuing their own economic interests. There is at best only limited recognition of the desirability of specifying *all* alternatives—and little capacity to evaluate them when presented to the agency from outside.

The Commission's consideration of the domestic satellite question provides ample illustration of this principle. The possibility of domestic satellites for the United States was first raised not by the FCC, but by ABC. The Ford Foundation subsequently filed a proposal that radically changed the frame of reference in which the question was being discussed—including the concept of a "peoples dividend" from the public's massive investment in the space program.

But for the Ford Foundation's proposal, I do not believe the Commission would have considered these policy alternatives—or that alternative proposals for adequate funding and interconnection of the Public Broadcasting Corporation would have received the impetus they have.

The problems surrounding spectrum management raise comparable issues. The Commission serves as a replacement of the free market in allocating this resource.

Most other resources in our society are allocated by those market forces, and the role of economics in our understanding of efficient resource allocation is paramount. One would, therefore, expect that economic analysis would be a major tool in the Commission's undertaking of this task. But as far as I know there is not one economist on the Commission's staff who is at all concerned with the spectrum allocation and management function.

It is not a question of there not being *enough* resources in this area—it is that there are no resources being devoted to it at all. When one realizes that most new developments in communications technology, such as satellites, depend upon the availability of radio spectrum, one can understand the handicap that is placed on efficient Commission decisions throughout the entire range of policy matters it must decide.

There are some efforts being made to rectify this situation. The office most concerned with spectrum management at the Commission

is moving to add a couple economists to its staff. But, once again, the time when the Commission will be able to make consistently intelligent decisions about spectrum utilization is simply not in the foreseeable future.

The magnitude of the problem can perhaps be seen from the Department of Commerce advisory panel recommendation of a couple years ago which suggested that a governmental effort of perhaps \$50 million a year would probably be necessary for this task alone—2½ times the FCC's current entire budget. The panel believed such expenditures justifiable in terms of more efficient use of the spectrum and its attendant contribution to the functioning of the economy.

In many ways, the Commission's actions are of the nature of crisis management—a crisis that would be unnecessary with adequate attention to policy planning and analysis. The Commission has made almost no use of market simulating techniques, such as user fees, in its allocation process.

Let me insert a little detail to make this clearer. What I am talking about with regard to spectrum management is the allocation of radio frequencies to business and other private users, that is, users other than the Federal Government: police departments, taxicabs, hand-held two-way communications that may be used in a warehouse or as part of a construction project, or whatnot.

We estimate, for example, that any operation in our economy that requires the use of mobile equipment—delivery trucks or something of that sort—can be operated with about 60 percent of the equipment with mobile radio communications as is required without it. The demand for radio frequencies far exceeds the supply, and the system has never really been very effectively managed.

We have simply made frequencies available to those who asked, when they asked, and some get unduly congested and others are really under-utilized. We don't really have a very good data base as to where the transmitters are and what geographical areas are now covered.

That is the kind of use I am talking about here and the nature of the economic impact.

One of the Commission's primary responsibilities in promoting the public interest in broadcasting is the determination of the industrial structure of the industry. The Commission must approve the competitive interrelationships and business practices of the industry. It is elementary economic theory that the structure of an industry and its competitive practices profoundly affect the performance of that industry, its capacity to serve consumer tastes and respond to market forces or other forms of social control.

This area of Commission activity has been of great concern to me, as I have detailed in many opinions and articles during my tenure. The Commission's failure to exercise its responsibilities in this area has resulted in the already overtaxed Antitrust Division of the Department of Justice becoming the primary force for enforcement of competition where one would expect the Commission to play the dominant role.

Thus, we have the Department of Justice successfully opposing the ITT-ABC merger—in a case appropriately titled, "The United States

versus the FCC"; successfully obtaining a consent decree divestiture of a television station from newspaper owners after the Commission had expressly approved the relationship in a recent renewal action; successfully opposing a proposed TV station-newspaper merger in another community; and filing a request for hearing and divestiture in another community where the Commission has regularly approved the concentration situation.

The Department has also taken strong pro-competitive positions in numerous other Commission proceedings. The Department has not only felt the need to intervene to promote competition, it has done so with spectacular success—often in opposition to the Commission's natural tendencies. And it was the Department of Justice's intervention—not action by the FCC—that resulted in aborting of the proposed mergers between Transamerica and Metromedia as well as that of Westinghouse and MCA, Inc.

There are two conclusions with regard to efficiency in Government that can be drawn from this description of the manner in which competition is promoted in the broadcast industry. First, one Government agency, already overtaxed, must undertake the responsibilities of the agency charged with primary responsibility.

Secondly, the performance of the industry in question necessarily suffers from the neglect of the useful effect of competitive forces. Competition is often a superior substitute for Government regulation. Unfortunately, the Commission devotes very little analytical resources to problems of industrial organization in the broadcast field. What little resources the Commission possesses have deteriorated in the last 5 years, and have been generally downgraded in the Commission's decisionmaking process.

There is a footnote to the problem of media concentration which illustrates the Commission's handicaps. For some 10 years the Commission has been considering the appropriate role for cable television—sometimes called CATV. CATV could affect concentration and user access. It presents an alternative to the present method of program distribution.

It is the Commission's responsibility to choose the most appropriate mix of over-the-air and cable technologies in achieving the Nation's goals for its mass communications system. This has been an extremely difficult decision for the Commission. Almost no resources of an analytic, systems evaluation, or policy planning nature are now being employed by the Commission in this problem.

By contrast, the Ford Foundation is sufficiently concerned that it has funded a roughly \$150,000 study at the Rand Corp. to evaluate the policy alternatives in CATV. The Commission, on the other hand, suggested some policy alternatives in December 1968 and solicited outside response.

I think it fair to say that the Commission views solicitation of the views of outside economic interests as a substitute for internal research and analysis. For whatever reasons, it certainly is not doing even as much as the Ford Foundation in trying to determine the most efficient and wisest national policy in this crucial area.

Again the Commission is willing to wait to see what accumulates in the "in-box" while it hopes that policy resolution is made elsewhere.

And Congress meanwhile is unable to rely on its expert agency for effective policy determination—or even some assistance.

In common carrier regulation the Commission has roughly 100 professionals who are responsible for regulation of the interstate telephone system dominated by the multi-billion-dollar Bell Co., satellites—including Comsat, international cable communications, and private microwave systems.

In many ways it is remarkable that the Commission has achieved as much as it has with such limited resources. But the Commission has not yet, for example, evaluated the rate of introduction of new technology in the telephone industry. The Commission is simply without the capacity to review the technological decisions that are made in that industry, and this is especially critical when one realizes that the industry is vertically integrated from research through production to service.

I do not now reach the question whether this is the most appropriate organization of the industry. But even if it is, the planning for introduction of new technologies is made almost exclusively by the Bell System, without any public review at all. The Commission may affect Bell's decisions through a variety of regulatory policies, but it is almost completely unaware of their impact.

Apparently the assumption is that what is good for Bell is good for the country. That may be so. But there is no theoretical reason why it should be. I am not so confident that the decisions of a monopolist are always the correct ones.

The thrust of my remarks is simply that the use of economic analysis to judge the efficiency of regulatory agencies involves much more than the allocation of their relatively meager budgets. The planning-programming-budgeting system must be modified to relate goals of regulatory policy to the expenditure of the agency's funds on decisionmaking.

The economic analysis of government turns on the relationship of alternative actions to goals. But regulatory goals are typically specified in only the most general statements and neither the measurement of achievement or the evaluation of alternatives is possible. Yet the impact of this sector of governmental activities on the functioning of the economy and the efficiency of government is almost impossible to overestimate.

Some have argued that the regulatory commissions serve little purpose in our society save as a device to serve big business, at the taxpayers' expense, by permitting industry to do with impunity what would otherwise send its corporate officials to jail. Some economists and commentators argue that many regulatory commissions are a dis-economy—that prices are higher and service worse with them than it would be without them. (Posner, "Natural Monopoly and Its Regulation." 21 Stat. L. Rev. 548 (1969); Kohlmeier, "The Regulators" (1969).

I am not prepared to go so far, at least not this morning. If such charges could be documented fully, I would agree that the agencies should be abolished. Until then, however, I would prefer to make every effort to attempt to improve their performance, through means such as this very inquiry by the subcommittee.

I cannot close a statement about economic performance without a comment about human performance. There is a growing malaise in

this country about the quality of life. It relates not so much to facts as to feel. People do not need scientific indicators to tell them that New York City's air doesn't feel good in their lungs. An economist's analysis is not much help to someone whose personal emptiness and frustrations increase in direct proportion to his material possessions. It doesn't feel good to talk to tape-recorded messages over the telephone and get mail written and addressed by computers.

I saw a bag of popcorn from the A&P store. It came in a clear, plastic bag and a machine had written on it "artificial color and imitation flavor." This sums up, in my judgment, a great deal of what may be wrong in our country today.

This is not a matter of a "generation gap"—although it does seem harder to keep one's sensitivity with age. Our society doesn't make its older people feel any better than its young—if anything, worse. It is middle-aged, middle-class housewives who are picketing the supermarkets' prices—not their teenage daughters. People are tired of everything breaking down and having to take it back to the store. Someday somebody is going to get up from his three-martini lunch to discover that this is the day the world wouldn't work. Everything will break down at once.

People are tired of seeing millionaires go tax free while their own taxes increase; sick at seeing agricultural subsidies averaging \$200,000 a year for the larger beneficiaries while the Department of Agriculture is unable to find enough money to feed the hungry; cynical at road signs warning of \$100 fines for littering, while corporations back their factories up to the river where they squat and dump corporate effluent by the ton into the city's water supply.

Television is not the only sick influence in our society, but it is one of the most significant ones. It leaves half of the American people dead in the water each evening. It force-feeds external additives like hair color, deodorant, mouthwash, headache, and sleeping pills, coffee, cigarettes, and beer to a bewildered people in search of "more"—instead of the stimulation to live the kind of life that can only bring the satisfactions they seek.

Well, if the regulatory commissions—which believe themselves to be servants of the industries they are supposed to regulate—don't even do a good job of serving industry, one can be sure they do an even worse job of serving human life. As Mason Williams says, "Government makes better deals with business than it does with people." It may be a subject outside the direct jurisdiction of this subcommittee, but I hope you may give some attention to the quality of American life, as well as its quantity.

Thank you, gentlemen.

Chairman PROXMIER. Thank you very much, Mr. Johnson.

Mr. Johnson, you have stated that the FCC possesses no central policy planning unit and, in effect, no capability to analyze or evaluate the broad economic implications of Commission decisions. Will you tell us first what the Commission's staff resources are—that is, whether there are economists or others trained to analyze the impact of Commission decisions—procedures employed, and the matters considered when the Commission makes its decisions?

Mr. JOHNSON. I would be happy to go into this in whatever detail you would wish. In order to give you precise figures on the number of personnel, I would need to supply a statement for the record.

In brief, I can say I would be surprised if there were more than a half-dozen Ph. D. economists anywhere in the FCC. The overall organization of the agency is in bureaus. The power rests with the bureau chiefs, not with the Presidential appointees, which is the pattern in most governmental agencies, of course. The Commissioners do not have available to them—

Chairman PROXMIRE. When you say the power rests with the bureau chiefs, not with the Commissioners—

Mr. JOHNSON. I think that is the pattern, probably, in most agencies.

Chairman PROXMIRE. Well, you say that, and we can accept it or not. What you are telling us is that, as I understand it and perhaps I am misinterpreting your statement, the bureau chiefs are career people who have been there for years, who understand the situation from having studied it for so long, and with a staff with which they work very closely.

They don't actually have the power that the Commissioners have. The Commissioners can come to any decision they wish. It may be a stupid decision. It may completely ignore the bureau chiefs. It sometimes does, doesn't it?

Mr. JOHNSON. Yes, but in the nature of things, very rarely so. The bureau chief has the resources, the personnel. They look to him for promotions. That is their principal orientation.

Chairman PROXMIRE. The dependence on the bureau chiefs is because of the bureau chiefs' superior staffing, knowledge, and experience; is that it.

Mr. JOHNSON. That was not my characterization necessarily, although that is part of it. I am saying principally it is the de facto power that rests with them because the Commission's role is essentially one of putting an imprimatur on proposals that are presented to it by the staff, and the person with ultimate authority in deciding what the staff position will be is the bureau chief.

The Commission is then confronted not with a choice of alternatives, but with the option of either accepting or rejecting that which the bureau chief has proposed.

Chairman PROXMIRE. The Commissioners have no independent economic analysis or other advice that has not come to them through the bureau chiefs?

Mr. JOHNSON. The short answer is yes, you are correct. The Commissioners have available to them, each Commissioner, one legal assistant and one engineering assistant. In my case, I happen to have chosen to fill the position that would normally go to an engineering assistant a man who has some background in economics, Bob Thorpe.

But there is no unit to which I can turn as a Commissioner that bears any title like Assistant Secretary for Systems Analysis or Office of Program Planning, or Chief Economist, or anything of that sort.

Chairman PROXMIRE. You are an extraordinarily able man. I don't mean that to flatter you. Obviously, you are, on the basis of your record. We all know you are. Why would it be so hard for you to simply tell the bureau chiefs, "We don't like your decision. We don't

think it is merited on the basis of your analysis. It is inadequate. Go back and give me some alternatives. I want a basis for choice. I want you to give me four, five, or six, whatever number you think will be appropriate alternatives, and I will make my decision on the basis of those."

Mr. JOHNSON. I regularly do that at the Wednesday meetings. The problem at the FCC is that you have to count up to four to get a majority of seven. It is very difficult to count up to four. It is difficult to get a majority of the Commissioners who are dissatisfied with the product that they are now getting.

In fairness to the other Commissioners, I should also say that there is a tremendous workload of the Commission. If you are presented with an item late Tuesday afternoon for a Wednesday morning meeting that has to be resolved by noon which doesn't have any alternatives in it, and you have 65 other items you have to pass on that day also, the amount of time you have for sending it back or for independent research is necessarily limited.

Chairman PROXMIRE. Let me dig into it by asking if you will describe what you consider to be the most serious limitations in the FCC decisionmaking process, using a typical ratemaking case or application for renewal of a TV license to illustrate your point, or any other example that you think would be appropriate, so we can see a good, hard example.

Mr. JOHNSON. You could almost pick at random from any Wednesday meeting, decisions in cable television which I have described; telephone ratemaking I detailed at some great length in our decision in 1967.

Basically, when we regulate telephone rates, we tend to talk about what we are doing in terms of the 19th century metaphysics known as public utility regulations. We talk about things like rate base, rate of return, and things like that. It is very difficult to get anyone, even the representatives of the company, to talk in terms of the role that the telephone plays in an industrialized society, as part of our economy.

During the past week, the company is coming in and asking for something between an 8- and 9-percent return. I asked them: "How would the country be different if you were to have a 6½-percent rate of return? How would the country be different if you were to have a 10- or 12-percent rate of return?"

The company is unable to deal with that question at either end of the scale, which is rather shocking, when one stops to think about the millions of dollars it would mean to their shareholders if only they were prepared to discuss it.

Chairman PROXMIRE. Could they do better if you gave them advance warning that this question was going to be asked, gave them a couple of weeks to work it out?

Mr. JOHNSON. They had a couple of years to work it out. I, at least, pressed the same question with some force during our rate hearing a couple of years ago. I have returned to the issue many times with them informally since.

Chairman PROXMIRE. Then you feel that the most serious limitation is just the failure of the Commission and of industry to come to grips with the really fundamental questions?

Mr. JOHNSON. I think it is a lack of data. It is a lack of analysis. It is a lack of posing alternatives. It is a lack of independent resources to evaluate the information given to us by others. It is an in-box mentality that tends to react to what is around that needs to be disposed of in terms of the way that it has been presented to the Commission by those who have the most to gain economically from the outcome.

Chairman PROXMIRE. How would you reorganize the FCC, or what changes would you make to better enable the Commission to carry out its functions?

Mr. JOHNSON. I think we clearly need more professional resources than we have. I think a central policy planning, economic analysis unit responsible directly to the Commissioners, rather than to individual bureau chiefs, is clearly called for as a start.

One can, of course, address in a more fundamental fashion why we have the regulatory commissions at all, and if there were to be fundamental reorganization in Government, where these functions might be allocated.

I think another way to approach it is simply to go through the areas of activity the Commission is involved in and ask with regard to each, what is the policy, what is the purpose of this activity, what are you trying to achieve, how do you go about measuring whether or not you are achieving it? How would you know if you ever were to be successful in this field?

In many areas where we are making decisions on a case-by-case basis, I think the grounds for the decision, if they were known, could be embodied in general rulemaking. I think it would be of greater help to industry as well as those who are studying the work of the Commission, as well as the Commission itself.

Chairman PROXMIRE. So if you could define your objectives, or at least discuss and understand your objectives so the objectives would be more clearly in mind, then you could begin to develop a system of analysis that would improve the performance of the FCC?

Mr. JOHNSON. That is right. I think it is essential, as most who have studied the FCC and the other commissions have concluded. Judge Friendly, in his book on administrative agencies, said that what is essential is that the FCC could do something so that a policy will emerge. This comment of his was directed to comparative hearings.

The Commission is not particularly inclined to enunciate policy statements with clarity and conviction. On those rare occasions when we do, we then spend most of our time waiving the policies. Applications for waivers come along. It is very difficult to predict how they will be disposed of. It is very difficult for me, as a Commissioner, to predict what decisions the Commission will come to on a given case.

Chairman PROXMIRE. My time is up. I will be back.

Congressman CONABLE?

Representative CONABLE. I am sorry I didn't hear your entire statement, Commissioner Johnson. It certainly sounded lively from what I heard.

I have been trying to figure out just what qualities you expect in a Federal Communications Commissioner. You talk about expertise in communications matters, general business experience, economics. I take it that really it is difficult to put your finger on what kind of a man you are looking for.

You are looking for somebody who is going to be alive and concerned about policy. Do you have anything further to say about these qualities that we should be looking for in such officials?

Mr. JOHNSON. Sure, I would be happy to. My standards are really very modest in terms of selecting commissioners for regulatory commissions. In the FCC, I wouldn't say a man needed to be an expert necessarily in communications policy or anything that esoteric.

I would start by saying he probably ought to have an IQ of at least 110, somewhere along in there. I think he ought to be able to read and write. If you could find one who actually likes to read and write, so much the better.

Representative CONABLE. Do you think we have had serious deficiencies in these areas?

Mr. JOHNSON. I wouldn't wish to say so, but there are those independent commentators who have said that there have been some problems along this line.

I would say that he ought to have sufficient sense of internal confidence and security to not feel that he needs the job in order to have an income, the knowledge that he can always leave and get adequate compensation doing something else.

I think he should not want to be reappointed. I think he should not want to use the position as a means for getting a job in the industry.

I think he should take the job seriously, not take himself altogether that seriously but take the job seriously; be responsible about it.

I think he ought to bring a measure of independence to what he does.

I think he ought to try to inform himself from all points of view and not just listen to industry spokesmen. I think he ought to be mindful of the tremendous, overpowering predominance of what Dean Landis called the daily, machinegun-like impact of the industry on the Commission and try to conduct himself accordingly in order to get a balanced view of the issues.

Representative CONABLE. Do you consider an economic background helpful?

Mr. JOHNSON. Well, shucks—the more education you can get beyond the sixth grade, the better. If you can have a man who studied law or economics, I think that is probably an advantage. There have been times when we have had an engineer on the Commission.

But I think basically what you are looking for are the qualities that you want in a good Congressman or Senator, I think. You want a generalist, essentially. Hopefully, the FCC has engineers. Hopefully, it has economists.

I think you need a man who recognizes his own limitations, recognizes his need for expertise, has the capacity to use the product of professional experts when they are brought to him.

Representative CONABLE. Do you feel that the Commissioners would do better work with more expert staff directly responsible to them as individual Commissioners?

Mr. JOHNSON. I believe so; yes, sir.

Representative CONABLE. Of course, the FCC has policy control over only one aspect of the communications industry, and I take it that you feel they are doing a rather bad job in that area. I am think-

ing of another aspect of the communications industry. That is the Post Office Department.

I want to carry this parallel only a certain distance. With the Post Office we have direct policy control here in the Congress over rates, let's say, for postage. I question whether we are doing a red-hot job either.

It seems to me that once again we have a difficult responsibility, although the Post Office Department does have a direct responsibility and, in a sense, the FCC doesn't.

Are there any lessons to be learned from comparing the two situations, the situation in the FCC and the situation in the Post Office Department in the area of communications?

Mr. JOHNSON. I think it is useful. I think it is not at all far fetched to think of relationships between communications and transportation, and the Post Office Department is situated neatly in the middle.

Is it, after all, communication or transportation when you throw a bag of mail on an airplane and carry it across the country? It doesn't really make any difference. It is, in effect, a part of the communications process.

There are many areas in which we can trade off between transportation and communication. One of the proposed solutions to the commuter problem is to improve communication into the home with facsimile devices, closed-circuit television, and so forth, and enable some people to do professional work at home without the need to travel. We are doing this more in business every day.

Representative CONABLE. People receive many outside influences through the mail just as through their television sets.

Mr. JOHNSON. Yes. In general, I think if you are engaged in an operation, as, for example, I was as Maritime Administrator with the operations of the Vietnam shipping program, I think it is very helpful to have a single-headed agency. If, however, you are engaged in a policy formulation process, I think it is useful to have diversity, to have dissent, and to have open and public dissent.

I am critical of the FCC, but I must say one of its great strengths is the fact that it is possible for me to be critical. There are very few institutions in our society that make even internal dissent and open discussion possible, and almost none at all that have built into them procedures and expectations of external public dissent.

Certainly when you compare the military or the typical executive department or the typical corporation, you find it wanting in this regard. So there is a great strength in that feature of the FCC.

But the Post Office Department is principally an operations agency. I am glad there are not seven Postmasters General. So far as congressional review is concerned, I think that is basically healthy. I am one public official—formerly in the executive branch, and now in a so-called arm of Congress—who very much welcomes the interest and involvement of Congress in our activities.

Representative CONABLE. Don't you think there is a certain amount of overlap inevitable between the Justice Department and the FCC? You put great stress in what I heard of your statement on the failure of the FCC to regulate competition, the necessary intrusion of the Justice Department, apparently, in the light of the FCC's policies,

and really your Communications Act of 1934 does require you to consider other things than just the issue of competition.

You have to consider the issue of efficiency, for instance. So isn't there inevitably a certain amount of conflict between the two groups on issues of policy?

Mr. JOHNSON. Yes, I think a certain measure of conflict is to be expected. It is certainly appropriate and probably constructive. My point was, however, that it seemed to me rather ludicrous—it would be laughable if it weren't so serious for our country—that the FCC, with the much higher standard of “Will this serve the public interest?” will approve transactions which the Justice Department finds do not even meet its much lower standard of economic competition.

The Justice Department, after all, is very much like a district attorney in this regard. They can get themselves involved in a case or not as they choose, and have time and resources to do so. The FCC is required by law to pass on each one of these transactions.

A merger will come before us and one of the questions we must address is the impact of this merger in economic, antitrust, and competitive terms. Will it have an untoward effect on competition?

But that is only one factor, and a very small part of our consideration. We ought to be far more concerned about the impact in the marketplace of ideas. We ought to be far more concerned about the impact of the domination of the mass media that the FCC has allowed to go on unchecked in this country, the impact of this domination of the mass media upon our political process, how a poor Congressman or Senator can begin to vie with the fantastic political power that this industry now possesses.

It becomes ever more serious and severe as these large conglomerate industrial corporations gobble up the major mass media in this country to the point where now in the largest cities in the United States you are hard pressed to find a VHF network affiliated station that is locally owned by somebody other than the local newspaper.

For the FCC to consider all these public interest factors and find a merger perfectly appropriate, and then for the Justice Department—which has a much broader range of responsibilities in terms of industries and a much lower standard in terms of public interest, being concerned only with economic factors—to come in and challenge the FCC's finding really makes the FCC look pretty awful.

Representative CONABLE. Do you have any suggestions for ways in which the basic act should be amended that would somehow sharpen the FCC's function in this respect?

Mr. JOHNSON. No, sir. I just think the basic act ought to be enforced. I think somebody ought to take it off the shelf and read it very carefully and just do what it says. I think that would be wholly adequate to meet any of my standards, which are really rather minimal.

Representative CONABLE. You are not here advocating additional legislation, but simply the enforcement of the law as it presently exists?

Mr. JOHNSON. I would advocate no erosion of present legislation as the broadcasters are now urging upon you.

Representative CONABLE. Is this erosion embodied in some particular bill that is before the Congress at this point?

Mr. JOHNSON. There is a general interest on the part of the broadcasting industry in changing those provisions of the act which provide for the public responsiveness and responsibility of the industry.

Congress in 1927 and 1934, considering the Radio Act and the Communication Act, expressly recognized the inherent danger in a democracy of anyone gaining control over the mass media, and expressly warned against this, and expressly drafted the act to avoid the possibility of a small group of individuals gaining control of the mass media.

One of them said, in a democracy publicity is the greatest weapon that any man can wield, and so forth. They were very mindful of this problem. They predicted with precision what has happened to us today. They provided that, therefore, no one should own a station. Broadcasters are, after all, using public property, and when they use this public property they use it as a trustee; they use it in the same way you would go into a National Forest to drill for oil or graze your sheep. They use it for a term of years, in this case 3 years.

At the end of that time, their term is up and they have to stand reelection, the same way you do. You don't have to be impeached before somebody can run against you and they don't either. Anybody can come in and say, "I can do a better job of running that station." That is supposed to keep them on their toes.

It hasn't worked very well because the FCC conveniently has not administered that very strictly. But because once in 35 years we took it seriously, and in order to prevent this ever happening again during the next 35 years, the broadcasters are now urging legislation that provides, in effect—

Representative CONABLE. Is this the Boston affair you are referring to?

Mr. JOHNSON. Yes, sir. [Continues statement.] Legislation that provides, in effect, that no one can contest a broadcaster's license unless the FCC has first found that he is unfit to hold the license. This is equivalent, as the New York Times characterized it, to requiring that a public official be impeached before anybody can run against him.

Representative CONABLE. Thank you, Mr. Chairman. That is all. Chairman PROXMIRE. You are referring to the Pastore bill?

Mr. JOHNSON. Some have so characterized it.

Chairman PROXMIRE. That is what it is. It was introduced by Senator Pastore on April 29, 1969. I have a copy here which I will include, without objection, in the record.

(The bill, referred to above, follows:)

[S. 2004, 91st Cong., first sess.]

A BILL To amend the Communications Act of 1934 to establish orderly procedures for the consideration of applications for renewal of broadcast licenses

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 309(a) shall be amended by adding the following after the final sentence thereof: "Notwithstanding any other provision of the Act, the Commission, in acting upon any application for renewal of a broadcast license filed under section 308, may not consider the application of any other person for the facilities for which renewal is sought. If the

Commission finds upon the record and representations of the licensee that the public interest, convenience, and necessity has been and would be served thereby, it shall grant the renewal application. If the Commission determines after a hearing that a grant of the application of a renewal applicant would not be in the public interest, convenience, and necessity, it shall deny such application, and applications for construction permits by other parties may then be accepted, pursuant to section 308, for the broadcast service previously licensed to the renewal applicant whose renewal was denied."

Mr. JOHNSON. I believe there are some 20 Senators on that and now some 80 Members of the House.

Chairman PROXMIRE. You stated, and I quote you, I believe, "Broadcasters are putting pressure on Congressmen and Senators right now to pass a law that would, in effect, give them an uncontested right to keep their station." Did you say that?

Mr. JOHNSON. I don't know that I said it, but I wouldn't mind saying it. It is not a bad line.

Chairman PROXMIRE. You said it. I have a copy of the bill here and it says, reading the section which is quite short:

Notwithstanding any other provision of the Act, the Commission, in acting upon any application for renewal of the broadcast license filed under section 308, may not consider the application of any other person for the facility for which the renewal is sought, if the Commission finds upon the record and representations of the licensee that the public interest, convenience and necessity has been and would be served thereby, it shall grant the renewal application.

It is hard for me to see that that does represent much of a change from the policy that has been followed in the last 35 years. I would still think that if the Pastore bill passed, and whether it passes or not, it would still be perfectly proper and desirable and, I would think, the continued practice of the FCC, to require the licensee to demonstrate on the basis of his record that he has served the public interest, and the standards that would be followed could be stricter than they are now, depending on what the Commissioners want to require.

So I can't see that the Pastore bill would give the station in perpetuity to a broadcaster unless that broadcaster can meet high public standards. You obviously have devoted a great deal of time to this and I haven't. You are a very able fellow, so I would like to hear your response to that.

Mr. JOHNSON. It would be rather extraordinary, I would think, that the broadcasters would expend a tremendous amount of money and time that they have on this issue if, in fact, it would not change the situation at all. I think, in fact, it does change it and changes it quite dramatically.

As a practical matter, as you quite rightly point out, the administrative impact of what the FCC has been doing is not very different from what this bill provides. But the law is very much different. What that bill provides, as you just read, is that the FCC would be dependent upon, after this were passed, an evaluation of the filing made with it by the station. That is like saying whether or not you are going to be reelected is going to be determined by somebody's evaluation of what you file with some election commission about how good a guy you are.

Chairman PROXMIRE. There are two words. It says "If the Commission finds upon the record and representations of the licensee * * *" "The record," it seems to me, is a record that the FCC

requires a broadcaster to keep showing the public service hours, and the various programs that he has carried and so forth, and isn't that subject to monitoring by the FCC?

Mr. JOHNSON. I regret to say the FCC does not even subscribe to *TV Guide*, let alone watch television.

No, the FCC is wholly dependent upon what is filed with it by outside parties, and it is only in recent years that outside parties have recognized this and have begun to take a more active role before the Commission.

Chairman PROXMIRE. Can you say what the FCC is doing now? If they don't now subscribe to *TV Guide*, if they don't now make an outside effort of the kind you describe. But this says, "the record." It seems to me that should be interpreted, or I would interpret it, as meaning that the FCC can establish a record based on its own investigation.

Mr. JOHNSON. That is right. The FCC could. But the FCC hasn't and the FCC won't. We have to be realistic about it, Mr. Chairman.

Chairman PROXMIRE. The bill says if the Commission finds upon the record.

Mr. JOHNSON. That is right. We have a very little, skimpy record before us. As a practical matter, the record is what the licensee has filed with us, and if he has any wits about him at all, that is going to be a very impressive filing.

Chairman PROXMIRE. There is one other argument that I have heard from TV broadcasters, as have other Members of Congress, I am sure, and it seems to me this carries some weight.

It is true that this is a highly lucrative business, but it is also true that it does require a substantial investment, especially if they do a really good job. Wouldn't this tend to decrease the capacity of a TV licensee to provide the kind of service that is desirable over a period of 3 years if there is a good chance that he is going to lose it, even if he works hard and does a conscientious job. He still can have it taken away by somebody else who comes up and promises they can do more.

Mr. JOHNSON. There are two answers to that. The first, I think, is that as a practical matter, the performance of the stations that have been challenged has markedly improved, rather than the opposite. The activity of recent months has had a marked, salutary impact upon the quality of programming, for whatever reason.

The second answer is that we are talking about an almost statistically insignificant number of stations actually losing licenses. There are some 7,500 stations in this country.

Chairman PROXMIRE. You are talking about radio stations?

Mr. JOHNSON. Radio and television.

Chairman PROXMIRE. Mostly radio in that statistic?

Mr. JOHNSON. That is correct. That means with 3-year licenses that about 2,500 are being renewed every year. If a couple stations a year were to lose a license, you are talking about one-tenth of 1 percent, and so far that has yet to happen because every case before the FCC that has involved a challenge is not yet resolved or is on appeal.

But even if two or three a year were to lose licenses and responsibility were to be transferred, what you are saying is that there are within the broadcasting fraternity those who feel that they are not in the upper 99.9 percent of the broadcasting industry.

I would say if a man really fears that he cannot meet that kind of rigorous standard, then probably it doesn't hurt him to be a little bit frightened. I think the responsible broadcasters in this country, and there are responsible broadcasters in this country—men who recognize their role, who recognize their responsibility, who recognize they have an obligation to do something more than profit-maximize—they are not afraid of the FCC. They are not afraid of losing their licenses.

Chairman PROXMIRE. Do you feel if this bill passed, if you got vigorous commissioners who were conscientiously appointed by the President, the kind you just described to Congressman Conable, there would be no reason in the world why you could not deny under the Pastore bill three or four licenses a year, but several hundred?

It says if the Commission finds upon the record that they are not serving the public interest. So it seems to me it is not this bill which, absent some kind of economic analysis, which, of course, is the purpose of this hearing, which you indicate the FCC is not capable of providing, you can't really tell me whether or not there would be an economic problem, not because you do not have the native ability, but because you just don't have the economic analysis in front of you.

If you should hold over the head of TV stations in Milwaukee, New York, Chicago, and elsewhere around the country the notion that there was a good chance that they would lose their license, do you know what economic effect this could have, when your FCC on the basis of your testimony this morning does not make a real analysis, in depth, does not have the capability to do so, of the economic requirements for a television station, how much they put into it, how much of a risk would be involved if they really had a serious chance of losing their license and good performance wouldn't be enough? You would have to match a performance against somebody else's pledge or promise.

Mr. JOHNSON. We do have some economic data. We know that last year there were on the order of 120 or 130 television stations that earned over \$1 million. We do know that the industry across-the-board earns approximately 100 percent rate of return annually on depreciated capital investment.

Chairman PROXMIRE. How do you know that?

Mr. JOHNSON. Because they file with us what their depreciated capital investment is worth and they file with us what their profits before taxes are. That works out to be about \$500 million a year. The industry in total grosses close to \$3 billion a year.

Chairman PROXMIRE. Do their profits after taxes represent a return of about 50 percent, then?

Mr. JOHNSON. It is probably as lucrative a business as can be found in this country. I think it would be impossible for the industry to make the argument that there would be any economic handicap to it. This is borne out by the fact that I cited earlier, which is that the typical response of a station under challenge has been to improve its programing rather than the other way around.

I think we need to lay our cards on the table here, Mr. Chairman. I think what we are talking about is political power, and I think it ought to be addressed as such. You talk about what kind of men are going to get appointed to the FCC. The same kind of political forces

that have dictated the introduction of this bill, the same kind of forces that play on the FCC, are the same forces that play upon the President of the United States in making these appointments.

We are going to witness that in the next couple of weeks, I rather suspect. The President is no different from everybody else who must run for office in this country. He, too, must go to the broadcasters to ask for time. He, too, can only reach his constituents in the most effective way by going through their medium. He, too, must raise the millions of dollars every election time, principally from big business, to pay to this other big business, to get back a part of the time from this public resources that the broadcaster is committed by law to provide for free.

Last year, nearly \$60 million had to be raised in this country to get some time from these guys to let those who were running for office talk to the people of this country about the issues and about their candidacy. I say that is wrong. I say you gentlemen should not have to be in a position where you must be beholden to the broadcaster. You should not have to be in a position where notwithstanding your desire to do the right thing, you know the power that these men have over you.

You know that you cannot engender the animosity of the broadcasters in your State or your district without standing a very substantial risk of losing the next election. I say that is a danger to the democracy of this country, and I say that is a very serious problem.

This bill is symptomatic of it, and the actions of the FCC are symptomatic of it, and the kinds of appointments the President of the United States is going to make to this Commission are symptomatic of it.

Chairman PROXMIRE. You may be right. I have run statewide in my State six times. I have lost three elections and won three. That is batting 500. In every case, of course, the TV stations could have helped or hurt me. They didn't do either one in any of the elections in which I ran, although I recognize TV is a very powerful media.

I had at one point a big battle with the Wisconsin broadcasters. I praised Newton Minow on the floor of the Senate when he left. They thought that was a very bad thing to do.

Mr. JOHNSON. We all make mistakes.

Chairman PROXMIRE. They were infuriated. I got all kinds of letters. They didn't take it out on me in any way. Maybe they couldn't figure out a way to do it.

You say they have this power, I think, really, they are in a position where they really can't wield the kind of intimidating power that you are talking about. I don't see precisely how they can do it. Maybe there are ways in which they can give a little better slant. They have to be very careful about that.

As far as I am concerned, they have never done it to me. I think in view of the fact that at least in some of the statewide elections I have run in, six, some of the TV broadcasters would be unhappy with me, but the newspapers have cut me up and done me a lot of harm, I think, and I have lost some votes because of what they have done. They have every right to do it. But the TV stations have never done this.

Mr. JOHNSON. I am not suggesting a slanting, although that is a problem. We have documented cases in which broadcasters have indi-

cated that they wanted news slanted. But that is not what I am talking about now. I am saying, first of all, the broadcaster determines the mood in a district. I am thinking of the broadcaster who told the black disc jockey that he didn't want him putting out any news because he didn't want to educate the Negroes of that community at the broadcaster's expense.

So when you go into your district and start talking about poverty, the ABM and these other problems, you may find a constituency that doesn't know what you are talking about, that thinks you are pretty weird, because they have never heard of these problems. This is the first way in which he can effect you.

Chairman PROXMIRE. That is not true of Wisconsin. It may be true elsewhere; maybe in Texas.

Mr. JOHNSON. No; it is not. I am an Iowa boy myself, Senator.

Chairman PROXMIRE. You went to the University of Texas; didn't you?

Mr. JOHNSON. Yes; a great university. But we have the highest literacy rates in the country in Iowa, and we are very proud of that fact.

A broadcaster can affect you by whether or not he makes time available to you for weekly reports to the people. He can affect you by how much he puts you on the news. This is all before the election takes place. When the campaign and election comes around, he can determine how much time he is going to permit you to buy even at his exorbitant rates. He will determine what kind of a format he will put you in.

Chairman PROXMIRE. He has to do this in a framework of reasonable equality. Maybe there are some examples, and I am sure there are, with 7,000 stations.

Mr. JOHNSON. He doesn't have to do it with equality prior to the campaign. A broadcaster in your State can choose to provide you a half-hour of time every week for a report to the people from Senator Proxmire, or he can decide not to do that.

Chairman PROXMIRE. But when broadcasters have done this, for instance, in one congressional district the present Secretary of Defense, Melvin Laird, was a very popular Congressman, a Republican Congressman, had the opportunity to make a report to the people on a TV station as a Republican Congressman. But they made a great effort to get the Democrats to do it. I was the Democrat they happened to select. If it hadn't been me, it would have been Gaylord Nelson, the other Democratic Senator.

They did this not because they liked me or preferred me to Melvin Laird, but it was because they recognized they had the responsibility to show a balance and, of course, there was the FCC Commission which had some influence on their future. It seems to me that the experience I have had tends to refute the terrible power which you imply that the TV broadcasters have.

Mr. JOHNSON. I am really delighted to hear that, because I had the impression from many of the Congressmen and Senators I have talked to up here—off the record—that while they were unable to say anything publicly they were very concerned about the rising costs of campaigning.

Chairman PROXMIRE. I think that is true.

Mr. JOHNSON. And, in general, the power that the broadcasting industry was able to wield in the House and the Senate when compared with the power of other industries and their lobbies.

Chairman PROXMIRE. I have taken too long. I do want to conclude, though, by saying that I think politicians are perhaps a little more sensitive than they should be. You know, when there is an article in the newspaper, or several articles in a newspaper praising a politician or Senator, he doesn't see them or feel them, but when there is one word of criticism, we are very sensitive to it and we tend to react pretty strongly to it.

Mr. JOHNSON. You get over that if you are an FCC Commissioner.

Chairman PROXMIRE. If we feel maybe a television station is giving our opponent a little more than they should, we are inclined to give that a little more weight than we should. My own feeling is on the basis of everything I have seen, and heaven knows the broadcasters of my State and of the country are not liberals, necessarily, not liberals at all, still they haven't been unfair to me. I just haven't seen a consistent record of unfairness in television to anyone.

Mr. JOHNSON. Congressman Conable, do you wish to endorse the broadcasters of your district as well?

Representative CONABLE. I don't know anything about that. But I do want to make one point.

I am concerned about the tremendous lengths of time that are involved in proceedings before your Commission. I wonder if this isn't a serious problem.

I quite agree with you that you are likely to get, if a fellow thinks his license is in jeopardy, an upgrading of the effort to serve the community and I think that is a desirable thing. I wonder if there is some way in which we can avoid having the uncertainties attendant on license renewal become avenues of harassment, avenues of perfectly tremendous legal expense to people who may not really have any solid reason to fear the losing of their license?

It seems to me, because of your sensitivity to be sure that everything is just as it ought to be, that perfectly tremendous amounts of time and tremendous amounts of money are involved. It seems to me also that because of the cumbersomeness and the lengths of time involved before the Commission, that frequently you freeze out people in applications for licenses that don't have large amounts of money to gamble on legal proceedings.

Is this a legitimate concern?

Mr. JOHNSON. Yes, I think it is. I think you can trust to the ingenuity of the FCC to come up with a way of protecting the industry against the kind of thing you describe, however. It has certainly been very ingenious in keeping the public out. I think it can be equally ingenious in preventing unwarranted harassment of responsible broadcasters.

I, for one, would acknowledge that it should. I don't think that a man who has been providing outstanding public service in his programming over a period of years ought to fear that any irresponsible, fly-by-night who walks in and challenges his license is going to be able to put him to a tremendous amount of expense and harassment for a

long period of time. I think the FCC can adequately deal with that problem when it arises.

Representative CONABLE. By the same token, isn't it likely to be a pretty expensive thing to challenge?

Mr. JOHNSON. No question about it.

Representative CONABLE. Is there any way we can improve the procedures over here? I realize that you are dealing with a very substantial property right. Whether you call it a property right or not, that is the effect of it. Therefore you have to provide very complete safeguards for both those who want to challenge and those who want to protect.

Mr. JOHNSON. That is basically the problem. Whenever you have substantial economic interests that stand to gain by keeping the procedures complex, it makes it very difficult to simplify them. That is a part of our problem.

Representative CONABLE. I have been concerned about little people from my area who put in for a radio license and who just absolutely are awash in a sea of redtape and find themselves having to hire very expensive counsel and very expensive engineers, frequently out of all proportion to the probability of return involved in the radio license that is involved for a very small community.

Mr. JOHNSON. I share your concern, and I, too, am especially distressed about delay. I had rather assumed that a 7-year term was going to be adequate for me to dispose of most of the matters that come before the Commission. I am now halfway through it and beginning to wonder.

Representative CONABLE. Justice delayed to this extent is justice denied to a degree.

Mr. JOHNSON. I think we could all agree to that.

Chairman PROXMIRE. Thank you very much, Commissioner Johnson, for a most stimulating morning. We most appreciate it.

Mr. JOHNSON. Thank you, Mr. Chairman. I enjoyed being here.

(The following questions were submitted by Senator Proxmire to Commissioner Nicholas Johnson, Federal Communications Commission, who testified at the hearing held September 16, 1969. His answers were submitted subsequent to the hearing:)

Question 1. You are a former Maritime Administrator. In that capacity you very effectively identified the serious problems that beset the maritime industry as well as national policy. I believe we now pay approximately \$750 million a year in subsidies to this industry.

Later we will have additional expert testimony about this subject. Because of your experience, however, we would also like to have your views on why this industry has apparently not kept pace with the maritime industries in other countries, why it does not seem to be competitive, and why it seems to have fallen into a state of relative disrepair.

What kind of changes in public policy would you like to see, and are you satisfied with the direction in which we are now going?

Answer 1. I have not studied maritime policy problems for some three and one-half years and am reluctant to comment about policy matters in that area. However, I am unaware of any fundamental changes since the middle of 1966. I believe the analysis embodied in positions then is probably equally valid today: the Administration program on maritime policy put forth by Secretary Boyd in 1968 [Hearings on S. 2650 (New Maritime Program) Before the Subcommittee on Merchant Marine and Fisheries of the Senate Commerce Committee, 90 Cong., 2d Sess., at 11 (1968)]; the Interagency Maritime Task Force Report of 1965;

and my testimony to the House Merchant Marine Committee in 1966 [Hearings on Vietnam—Shipping Policy Review Before the Subcommittee on Merchant Marine of the House Committee on Merchant Marine and Fisheries, 89th Cong., 2d Sess., ser. 89-18, pt. 1, at 3 (1968)]. The positive disincentives to efficiency and competitive behavior in our present subsidy programs for shipyards and ship operators are fully spelled out in those documents. At that time virtually all economists who were independent of the industry took the position that there was no economic justification whatsoever for the maritime subsidy programs; that there were, in other words, far cheaper ways to achieve such benefits as the programs might produce. Secretary McNamara took the position that there was no defense justification for additional subsidy expenditures.

The recent message by the Nixon Administration offers only an outline of its program and must be fleshed out before any definitive evaluation can be made on its merits. [5 Weekly Compilation of Presidential Documents 1480 (1969)]. It is, however, disturbing to read that the Administration was unable to come to grips with three of the fundamental questions—manning levels on American subsidized ships, operation of American-owned ships of foreign registry, and the ability of ship operators to purchase ships at competitive prices. The Nixon Administration professes the laudable goal of reducing the drain on the American taxpayer for subsidy paid to these special interests, but it proposes to achieve this goal by *increasing* this subsidy by \$1 billion over the next ten years.

It is ironic that one of the American innovations in merchant shipping—the LASH (Lighter Aboard Ship) concept—should have been put in operation first by foreign-built ships. The apparent failure of the Nixon Administration to deal with the problem of buying ships competitively may also manifest itself in plans for shipping Alaskan oil. At present ships transporting goods in the coast-wise trades must be built in American yards. There are many problems with the economic use of oil recently discovered on the Alaskan north slope, but many people are hopeful that this discovery can have a positive influence on reducing the costs of oil products in this country. However, so far as I know, there are no American yards able to produce the ships that may be required in this trade without costly modification in shipbuilding capacity; even then the capital costs to the oil companies for these ships would still be more than double what the companies would pay if they were allowed to purchase the ships on the open international market. It would be unfortunate indeed if these capital costs were to contribute to a decision that it was too costly to ship Alaskan oil to the rest of the United States.

Question 2. You assert in your prepared statement that "the performance of the industry in question necessarily suffers from the neglect of the useful effect of competitive forces." You refer to the broadcasting industry.

Can you document this? In what respects is the performance of the industry deficient? What evidence is there of the lack of competition in the industry? What kind of competition are you talking about, how would more of it improve the services?

Answer 2. There are three areas where the Commission has failed to employ fully competitive forces in the broadcasting industry and has sanctioned an industry structure that is unnecessarily concentrated. In each the U.S. Department of Justice has intervened, generally unsuccessfully, in an attempt to persuade the Commission to change its policy.

The Commission has authorized numerous instances of crossownership of media properties in local communities where more diverse ownership presumptively would better serve the public. In addition, when the Commission has allowed these concentrations, it has failed to exact any compensating public benefits from the licensees. Thus, there are more than 70 communities where the owner of the only daily newspaper owns the only broadcast outlets in the community. There are some 80 additional communities where a newspaper-broadcast station complex appears to dominate the media available in the community. The Department of Justice has taken action on its own in several of these situations, in court or before the FCC. Even a recent study of the National Association of Broadcasters suggested that a certain ownership situation it had studied called for remedial action by the Commission—a situation the FCC had sanctioned numerous times through the renewal process.

The problems with this type of industry structure in local markets are readily apparent. First, there are the traditional antitrust concerns with competition

for advertising in the market. Second, the residents of the community enjoy less diversity in the "market place of ideas" available to them. Finally, there is a severe question of concentration of political and economic power in the local community. This is often exacerbated when the media complex has significant local conglomerate interests, such as banks, real estate or industrial concerns, which add to its power.

Second, the Commission has permitted three network companies to completely dominate the program production and distribution of television fare to a point where the networks have virtual control over all prime time television programming. The result is an industry with the imitative behavior one finds in a three-firm oligopoly. This has occurred despite an eleven-year-old FCC proceeding designed to deal with the problem, and clear recommendations in that proceeding as to remedial action the Commission could take. Network concentration problems have been of concern to the FCC for more than twenty years. It is an area in which the Commission clearly has not moved as effectively as it might. The networks and their stations account for more than half the revenues in television. The American public is limited to three sources for its television programming fare in prime time.

Third, the Commission has only begun to inquire into possible problems with media complexes having significant non-broadcast or conglomerate interests. The classic case was the ITT-ABC merger where the Department of Justice undertook a thorough analysis of the difficulties arising from welding broadcast properties with a significant company in the area of equipment supply and new communications technologies. That case also raised the problem of conflicts of interest within a corporation trying to report and analyze the news objectively while also protecting its other corporate interests. We are now seeing the rapid formation of so-called "knowledge conglomerates" linking broadcasting-CAT—newspapers-publishing-computers-programming learning-movie production records and a host of related activities. In addition, there are numerous examples of pure conglomerates who own broadcast stations as part of their stable of properties. Reciprocity and possible intracorporate conflicts are areas the Commission knows little about, despite its clear powers and duty to inquire into the behavior of its licensees and the industry structure it approves.

Question 3. Recently there have been serious problems in the telephone systems in some of the large metropolitan areas. In New York City, for example, there have been some major breakdowns of telephone services, to the extent that some businesses have gone to the expense of taking out full page ads in the newspapers in an attempt to re-establish contact with their customers. One explanation for these breakdowns was offered by a representative of a computer firm. He said that telephone lines were being overloaded with computer information and that the telephone company has simply not expanded its physical facilities to take into account the increased demand.

Is there a danger, in your judgment, that some major city might be faced with a telephone blackout like the power blackouts and brownouts that have occurred? How many cities are now faced with the problem of reduced or impaired telephone service?

What has the FCC done to alleviate this situation? What should be done?

Answer 3. Telephone service problems have become more than annoying. Numerous state Commissions have held formal inquiries and the Bell System has made extraordinary efforts to try to rectify the situation. But I will not be surprised if matters get worse before they get better. A number of these situations will need a significant amount of lead time if the equipment corrections are to be made. Whether there will be breakdowns as significant as any of the power blackouts is a question to which no one really knows the answer. If the telephone company has significantly and systematically underestimated demand, especially in the area of computer communications, there may indeed be serious dislocations until Bell improves its ability to forecast. We are now confronting the evidence that Bell is relatively weak in this area. One could conceive of a situation where the telephone company was so unresponsive and took so long to improve its planning function that service problems would multiply to a real crisis.

I think it unlikely that there will be anything like the 1965 power blackout for telephone service. While Bell does not strike me as a demand-oriented company making adequate use of recent innovations in business planning, there is one thing it tries to avoid even more than service complaints and that is public

criticism. It has received more than the usual in the last few years and rightly so. But to remedy serious problems in telephone service that have been allowed to overtake us, we will do so at substantially higher costs than would have been the case if Bell had accurately estimated demand. Crash programs are always costly and the consumer must pay those costs. A monopoly is traditionally a conservative entity used to a rather settled life with only moderate change. This is not the environment Bell now faces and it will simply have to get used to the new environment.

The FCC has held some informal, off-the-record conferences with Bell and the other telephone companies about service problems. This is an area that is of legitimate interest to the Commission even though service problems are typically thought of as "local" because they stem from conditions in the local rather than intercity plant. Difficulty with getting telephone instruments at the local level or in securing a non-busy line to a local exchange also means the interstate system cannot perform correctly. There is also serious question as to whether Bell's rendition of distinct services and pricing policies do not in fact contribute to its serious peaking problems. Perhaps the FCC should announce public on-the-record hearings with sufficient notice and preparation to allow consumers to present their problems as well as time for the telephone companies to come in and defend what they are doing and plan to do.

Question 4. You recently made the statement, in your appearance on Face the Nation, that many TV stations are earning "well in excess of 100 percent return on depreciated capital."

How do you know this is true? You have testified about the lack of economic analysis within the FCC. Can you produce any studies backing up your statement? Assuming TV stations are making such profits, are they excessive, in your opinion? What rate of profit would be reasonable for this industry, considering the fact that the licensees must come up for renewal every few years?

Answer 4. The Commission does collect and publish aggregate data concerning the level of profits before taxes and the depreciated tangible investment in the television industry. I am attaching a copy of the Commission's report for 1968.* The Commission's resources in economic analysis are limited and are often removed from the decision-making process, especially in the area of broadcasting.

Any answer to the question of the appropriate profit rate for the television industry involves a number of considerations. There is great variability within the industry for station profits. Basically the most profitable stations are the VHF, network-affiliated stations in the largest markets. The importance of network affiliation is clear—83% of all network-affiliated stations in 1968 were profitable while only 33% of non-network affiliates operated at a profit.

Although the Communications Act clearly states that broadcasting is not to be treated as a common carrier, it also implies that the Commission should require something from its licensees in addition to profit-maximizing behavior in return for the free use of public property.

Unfortunately, the Commission has only sporadically questioned the profit maximizing behavior of its broadcast licensees. The normal attitude is that if the behavior is not illegal, profit maximization simply means more people are getting the service they desire. The result, in an industry where the government's licensing power assures an oligopoly, is a natural tendency for high profits to accrue to the oligopolist. If the Commission were to set standards for public service from its licensees, related to the resources of each, there might very well be a fundamental change in the programming practices of the industry. There could be an attendant decline in the level of oligopoly profits in the industry although much less than I believe most in the industry fear. The Commission might very well be able to change the incentive structure for the industry in such a way that its performance would more closely approximate the magazine or paperback publishing industries in diversity of source and variety of fare. "Profit-maximization" in the long run would necessarily include behavior keyed to retention of the public license to broadcast under Commission standards of public service and access. But today profit maximization with FCC approval means blind pandering to the lowest common denominator of public taste and tolerance while pushing programming and commercial policy to the margin of maximum short run and long run profits.

* (In committee files.) Federal Communications Commission 34th Annual Report, Fiscal Year 1968, Available from Superintendent of Documents, U.S. Government Printing Office, Washington D.C. 20402.

Chairman PROXMIRE. Our next witness is Prof. Stanley Surrey, who is a man with a most distinguished background and also with a highly controversial area in which he has to operate.

If there is anything more controversial than Mr. Johnson's area, it is Mr. Surrey's area. Mr. Surrey graduated from City College of New York and received his law degree from the Columbia Law School. He has served in the Federal Government with the National Recovery Administration, the National Labor Relations Board, and the Treasury Department. He has taught at the California School of Law, Columbia University Law School and, since 1958 has been the Jeremiah Smith Professor of Law at Harvard University Law School.

From 1948 to 1961 he was director of the American Law Institute program in taxation. From 1961-68 he served as Assistant Secretary of the Treasury for tax policy. Mr. Surrey has authored several articles and edited a number of books.

We are most pleased and honored to have you here. You may proceed in your own way.

STATEMENT OF STANLEY SURREY, HARVARD LAW SCHOOL

Mr. SURREY. Mr. Chairman, I submitted a statement to the committee.

Chairman PROXMIRE. You may proceed as you wish.

Mr. SURREY. Thank you. I appreciate the opportunity to appear before this committee to discuss the subject of the tax expenditure budget and its relationship to economic analysis and the efficiency of Government.

THE TAX EXPENDITURE BUDGET

Just what is the tax expenditure budget? The annual report of the Secretary of the Treasury, for the fiscal year 1968, contained for the first time an exhibit entitled "the tax expenditure budget." This exhibit provided a conceptual analysis of tax expenditures, followed by a classification of existing tax expenditures and the revenue amounts involved. The tax expenditures so analyzed, simply stated, are expenditures of Government funds that are made through the special provisions contained in the income tax laws.

I believe some quotations from the Treasury report will serve to describe both tax expenditures and the Treasury analysis:

As every taxpayer knows, income tax laws and regulations are complex. Much of the complexity derives from the numerous deductions, exemptions, credits, and exclusions allowed taxpayers in stipulated circumstances. Many, probably most, of these provisions exist because of the belief that they are directly related to the measurement of net income appropriate to an income tax.

But others appear in the tax code because of the belief that while not required to measure net income, the provisions promotes some other objective, such as economic growth or a desirable expenditure pattern by taxpayers.

In many areas the influence of the tax code on private economic behavior through these special tax provisions is of an amount

which approaches and, in some instances, surpasses that of direct Government expenditures directed to the same objective.

Each of these special tax provisions reduces Government revenues available for other purposes, much as do increases in direct Government expenditures. In most cases, direct expenditures or loan programs exist as alternatives for achieving the same purpose that the special tax provisions are designed to accomplish. Our Federal budget as presently constituted, however, does not report those tax revenues which the Government does not collect because income subject to tax is reduced by these special provisions and the various special credits, deductions, exclusions, and exemptions which they provide. The budget in its present form thus understates the role of Federal Government financial influences on the behavior of individuals and businesses and on income distribution.

As a consequence of these special provisions in the tax system (some provisions are in the statutory tax law and others appear in regulations and rulings), the personal and corporate income tax bases deviate in numerous ways from widely accepted definitions of net income. Numerous kinds of income are excluded from taxation altogether while others are included only in part. Various types of expenditures by households give rise to deductions which are subtracted from income.

These special tax provisions and adjustments have been controversial in varying degree at varying times. In many cases, differences of opinion persist as to whether or not the effects of these deviations on income distribution and resource allocation are desirable. This special analysis is not concerned with the desirability of these provisions. Rather, it lists the major respects in which the current income tax bases deviate from widely accepted definitions of income and standards of business accounting and from the generally accepted structure of an income tax, together with estimates of the amount by which each of these deviations reduces revenues. It also arrays these tax provisions in the functional categories under which direct expenditures are classified in the Federal budget.

The purpose of this analysis is to present information on the basis of which each of these special tax provisions and their revenue cost can be compared with other such provisions which entail a reduction in revenues, and with direct expenditures or loan programs which result in outlays of a similar magnitude. The inclusion of such information, in addition to the ordinary budget accounts, can clarify and present more fully the role of the Federal Government in various functional areas. This information cannot presently be obtained from either the budget documents or the Statistics of Income published by the Internal Revenue Service . . .

. . . The special tax provisions take many forms. Under some, certain types of incomes are excluded from taxation, a few examples being interest on State and local government bonds, half of realized long-term capital gains, social security benefits to the

aged, and employer payments for fringe benefits, such as hospitalization, surgical, and group life insurance premiums. Other special tax provisions are in the form of deductions for certain personal expenses, such as charitable contributions, medical expenses, and interest payments.

Other special deduction provisions allow business expenditures in excess of actual cost (percentage depletion, certain bad debt reserves) or earlier in time than the cost would become an expense under business accounting (agriculture, research and development, exploration and discovery of natural resources). Other special provisions provide a lower effective tax rate than is generally applicable, such as the lower statutory rate on Western Hemisphere trade corporations and the lower ceilings rate on long-term capital gains. Still other provisions take the form of tax credits (retirement income credit, investment credit).

Most of these special tax provisions are designed expressly to achieve objectives similar in nature to those of direct Government expenditures or loan programs. In each functional area, the Federal budget includes direct Government expenditures, direct Government loans, loans insured by the Government, and loan subsidies which have similar though perhaps not identical objectives. In each of these areas, such direct spending or loan programs would be an alternative method to accomplish the purpose which the special tax provision seeks to achieve or encourage.

We can examine several of these tax provisions to indicate how "tax expenditures" are alternatives to direct expenditures or Government lending programs. As a first illustration, consider the provisions which benefit the aged. The Federal budget lists under the functional category of "health, labor and welfare" large direct expenditures including the social security and medicare trust funds for the aged. But the budget contains no item to show the \$2.3 billion expended through the tax system to aid the elderly through the retirement income credit, the additional \$600 exemption, and the exclusion of social security retirement benefits. The same assistance could be achieved by additional transfer payments to the aged rather than by tax provisions . . .

. . . Direct expenditures for natural resources, as another example, are itemized in the budget but no items are presented to cost out the assistance the tax system provides these industries by permitting the expensing of certain capital costs, the use of percentage depletion in excess of cost depletion, and special capital gains treatment for timber and for iron ore and coal royalties. Direct expenditures could be tailored to achieve the same purpose as these expenditures through the tax system. For example, subsidies might be paid to encourage exploration and development of selected minerals or good forest management. (Annual Report of the Secretary of the Treasury, Fiscal Year 1968, pp. 326-328.)

This Treasury analysis, which related to the fiscal year 1968, was updated in a special submission made by the Secretary of the Treasury

to the Joint Economic Committee on January 17, 1969 in its hearings on the Economic Report of the President. It was there stated:

Tax expenditures are not disclosed in the budget and therefore are not subject to careful annual scrutiny in the budget and appropriation process. Budget outlay decisions, on the other hand, involve the departments and agencies, the Bureau of the Budget, the House and Senate program committees which are competent and experienced in their specialized fields, and the appropriation committees. Tax expenditures are not generally considered by the program departments and congressional committees concerned, and are not reviewed annually or periodically to measure the benefits they achieve against the amounts expended.

The purpose of this analysis is to present information which compares tax expenditures with direct expenditures or loan programs in various functional areas and thus to clarify and present more fully the role of the Federal Government in these areas. Such a comparison should be helpful in the allocation of public resources. (Hearings before the Joint Economic Committee on the Economic Report of the President, 91st Cong., first sess. [Jan. 17, 1969], p. 32.)

The Treasury analysis presented for the various budget categories—national defense, agriculture, natural resources, commerce and transportation, community development and housing, and so on, and for a special category not listed as such in the budget—though included in a special analysis—aid to State and local government financing—the amounts expended through the regular budget for these categories and the amounts expended through the tax system. The comparisons are interesting and revealing. In some categories, the tax expenditures exceed the budget items; for example, in community development and housing, the tax expenditures are nearly 200 percent of budget outlays; in commerce and transportation, 110 percent. In other categories, the tax expenditures are also significant; in natural resources, about 90 percent; health and welfare, about 36 percent. In only two categories, national defense and veterans, is the figure less than 10 percent.

I have attached to this statement copies of the material in the Treasury report and the submission to the Joint Economic Committee.

This then, is the concept of tax expenditures and the Treasury analysis of existing tax expenditures in the form of a tax expenditure budget. (The substance of my testimony today is that a tax expenditure budget is feasible and useful.) I, therefore, believe it should be a continuing task of the Treasury Department to prepare this tax expenditure budget annually.

The tax expenditure budget should be included as a regular item in the Annual Report of the Secretary of the Treasury and in the budget document, perhaps as a special analysis. I believe that the tax expenditure budget and such regular public presentation will contribute to economic and other analysis of tax expenditures and these in turn will contribute to efficiency and economy in Government.

FEASIBILITY OF PREPARING A TAX EXPENDITURE BUDGET

Let me first consider the feasibility of preparing a tax expenditure budget. As stated above, this Treasury analysis is the first presentation that has been made of this category of Government expenditures. Since it has been made public, I have heard no basic criticism of the presentation or the data.

To be sure, there are conceptual aspects involved, as the analysis itself describes. It is necessary to separate the special tax provisions—the “tax expenditures”—from the basic structure of the income tax. Here the analysis uses the standard of “the generally accepted measure of net income”—or, phrased another way, “widely accepted definitions of income and standards of business accounting and . . . the generally accepted structure of an income tax”—as the guidelines to separate the customary structural provisions from the special tax provisions.

Thus, matters such as personal exemptions, rates, and income splitting allowed for married couples filing joint returns are considered as part of the structure of an income tax based on ability to pay and therefore do not involve tax expenditures. Similarly, deductions necessary to the computation of business or investment net income are part of the structure of an income tax. But exemptions, deductions or credits that lie beyond the customary determination of net income—for example, excessive depreciation, percentage depletion, expensing of capital costs, exemption of State and local bond interest—are special provisions and thus involve tax expenditures.

These standards enable us readily to classify most of the income tax provisions. There are some residual items on which there can be difficulty or disagreement in the classification, but this aspect is minor in comparison to the large body of information made available by the tax expenditure budget.

There are also some problems associated with the estimates required. These problems largely stem from the incompleteness of the underlying data, and the continued task of analysis and estimate would serve to produce more complete data. The estimates, parenthetically, are “first level” figures, that is, they involve the revenue that would be obtained from a change in the tax provisions involved without anything else being changed. Hence, the estimates do not involve predictions of what taxpayers would have done in the light of change. Budget estimates of direct expenditures also do not involve the second-level effects of the expenditure itself, or its absence.

Continued refinement of the tax expenditure analysis would develop useful explanatory material to indicate this difference between first- and second-level effects.

Further analysis would also develop a more refined allocation of some tax expenditure items among the budget classifications. Thus, individual capital gains in the Treasury analysis are placed in a separate heading, since the existing data did not permit an appropriate allocation of the large amount involved—\$5½ billion to \$8½ billion—among the activities in the various expenditure categories,

such as agriculture, natural resources, commerce and transportation, housing and community development, and health and welfare. The capital gains special provisions cut across all these fields. While the use of a special heading avoids the task of allocation, it also results in an understatement of tax expenditures in those categories in which capital gains are significant, such as commerce and transportation.

Continued attention to the analysis of tax expenditures would improve that analysis, just as continued attention to the budget has improved the concepts and data underlying that document. The important fact for the present is that the Treasury analysis demonstrates that present data and analysis do make feasible a helpful classification and estimate of tax expenditures in the form of a tax expenditure budget.

Given the feasibility of a tax expenditure budget, what is its utility?

INFORMATION ON TAX—AND GOVERNMENT—EXPENDITURES

The first aspect to be stressed in considering the utility of the tax expenditure budget is that of information. The total of these tax expenditures is over \$45 billion. Now, \$45 billion of expenditures is a large amount to be lost or misplaced in Government accounts. Yet, this \$45 billion are in a real sense lost in our Government accounts—they do not show in the budget and they do not appear, for the most part, in Treasury Statistics of Income. Until the Treasury analysis was published, the data were not available to the public—and not comprehended within Government. No one really knew what was being spent through the tax system and for what purposes.

The fact that Government expenditures are actually over 20 percent higher than the current budget figures of \$190 billion—and revenues also higher—is highly important. So also is the fact that the Government is actually spending three times the budget figures to assist community development and housing and twice the budget figures on commerce and transportation and national resources. If direct expenditures of these amounts had been omitted or mislaid, the budget would certainly be discredited. Yet, tax expenditures are a form of Government expenditures and their existence is as important as direct expenditures for budgetary purposes. But until now, these tax expenditures have in effect been the hidden expenditures of Government.

It seems obvious that we should have current and detailed information on these tax expenditures. The tax expenditure budget would provide this information.

ECONOMIC ANALYSES OF TAX EXPENDITURES

Once we have the information on tax expenditures—the activities affected and the amounts involved—we can proceed to a wide variety of studies. Essentially, these studies would relate to the efficiency of Government. We should be finding out just what the Government is obtaining in return for the \$45 billion or more spent through the tax system.

When Government spends nearly a billion dollars on buildings through excessive tax depreciation and capital gains, what is it obtaining—how many additional buildings, of what types, in what areas? Are these buildings—which include office buildings, hotels, motels, shopping centers and the like—the types of buildings on which we should be spending Government funds?

When Government spends over \$1½ billion through the tax system on natural resources, what is it obtaining in the way of additional exploration and reserves; what kinds of minerals are involved and in what places are they located?

When Government spends over \$1½ billion through the tax system on agriculture, what activities and what areas are being aided? And are they in need of that aid?

When Government spends nearly \$2½ billion through the tax system for relief of the aged, just which of the aged are receiving these funds and how much in need are they?

We really know very little about the answers to questions such as these, questions which can be asked about each of our tax expenditures. Clearly, we are in need of applying the techniques of cost-benefit analysis and program planning to these tax expenditures, many of which have never been studied at all. Examples of relevant studies are the recent CONSAD cost-benefit study of tax expenditures for oil and gas and the econometric studies of the investment credit, which were done for the Treasury Department.

It is to be expected that the tax expenditure budget, by providing information on the activities and amounts involved, will prompt the necessary studies. It is also to be hoped that the various Government departments and agencies involved would themselves become more curious about these matters and seek to raise the relevant questions and then to answer them. At present, the department generally take the view that since it is not in "our budget," we needn't think about the expenditure or seek to ascertain whether it is in the public interest.

This, of course, is the real question—are these expenditures in the public interest? In many cases the question has barely been raised or debated, let alone answered. Some of these tax expenditures came quietly into the tax law decades ago through administrative rulings where the focus was on the exigencies of tax administration and not on expenditure policy.

Moreover, the amounts involved were small and the resource allocation aspects not perceived or then significant. Others were adopted by Congress years ago in much the same fashion. Only infrequently was there a deliberate desire to achieve a given public purpose through the allocation of resources. Yet today, many of these provisions are now defended in public policy expenditure terms, but unfortunately without any accompanying analysis and evaluation. The need for such analysis and evaluation is obvious.

PROMOTION OF EFFICIENCY OF GOVERNMENT

The Treasury analysis calls attention to the consequences for efficiency of Government that are involved in a tax expenditure budget. It points to this statement in the 1966 Economic Report of the President:

In a fully employed economy, special tax benefits to stimulate some activities or investments mean that we will have less of other activities. Benefits that the Government extends through direct expenditures are periodically reviewed and often altered in the budget-appropriation process, but too little attention is given to reviewing particular tax benefits. These benefits, like all other activities of Government, must stand up to the tests of efficiency and fairness. (Treasury Report, p. 327.)

It then goes on to state:

It is clear, however, that more efficient use of resources by the Federal Government is advanced if explicit account is taken of all calls upon budget resources, so that the importance of different budgetary objectives and the effectiveness of alternative uses, whether through direct expenditures, loan subsidies, or tax expenditures, may be fully understood, examined, and reevaluated periodically. (Treasury Report, p. 328.)

One aspect of increased efficiency would lie in the basic reexamination of the amounts now being spent through tax expenditures—a total that is over 50 percent of the Defense Budget. One suspects there is much waste and water in the Tax Expenditure Budget. It must be remembered that these tax expenditures are generally open-ended, in that the total to be spent is not predetermined, but instead depends on the degree of taxpayer activity. These tax expenditures are thus to be classified among the uncontrollable expenditures of Government, along with such items as interest on the public debt. But they need not be uncontrollable; they are simply presently just structured that way.

One also suspects that many of these tax expenditures would be framed much differently if cast as direct expenditures. Government would then be far more interested in what it is receiving for its outlays. The traditions respecting scrutiny, review, and skepticism are different for direct expenditures than for tax expenditures.

Another aspect of increased efficiency would lie in greater coordination between direct expenditure policy and tax expenditure outlays. At present, the various legislative committees of Congress and the Appropriations Committees legislate, determine, and coordinate our spending programs. But they have no jurisdiction over the tax expenditures.

In turn, the tax committees largely formulate the tax expenditures without any coordination with the legislative committee having jurisdiction in the areas involved or the Appropriations Committees. The

tax expenditure really operate as back-door financing of the activities involved.

This lack of coordination can only make for inefficiency and waste. The priorities in our regular budget programs do not appear to be reflected in our tax expenditures. The priorities—if that term can be applied to what has developed largely by happenstance—of our tax expenditures are not the priorities of our regular Budget. Nor has the expertise regarding substantive programs that lies within Government, legislative and executive, really been applied to tax expenditures.

A third aspect of increased efficiency would lie in the coordination of tax expenditures with overall Government expenditure policy. When the Congress or the President, or both, determine overall expenditure limits, those limits are applied to the regular budget programs. But the tax expenditures are immune from these limits. Hence, regular programs must often be cut back when a rational view of overall priorities and programs would have produced instead a reduction or slowdown in some of the tax expenditure programs.

Yet, had these tax programs been structured as direct expenditures, they would have no such immunity. In substantive terms, they do not merit that immunity any more than direct expenditures, yet their tax clothing serves to shield them. We have learned as respects the more traditional expenditure techniques that as long as any form of Government assistance is out side the purview of the Budget—be it a loan an interest subsidy, or a guaranty—that the absence of periodic review inevitably makes for waste and inefficiency and misdirection of resources. We now have to apply that learning to tax expenditures.

ALTERNATIVE METHODS OF GOVERNMENT ASSISTANCE

I would like to relate tax expenditures and the above comments to the subject of tax incentives and tax credits. We recognize that Government can allocate resources and assist activities through a variety of monetary techniques. It can use direct grants of money; it can lend money; it can guarantee loans; it can subsidize interest rates; it can purchase assets.

The Tax Expenditure Budget points to another alternative—the reduction of the tax liabilities of particular taxpayers through special tax provisions. In a given area, Government thus may use the traditional methods of assistance, or it may use a tax expenditure. The reverse is even more important—where the Government is giving assistance through a tax expenditure, it could give that assistance directly and need not resort to the tax system.

Therefore, once it is decided that Government assistance is to be given—and this decision is, of course, a basic prerequisite—then the question arises, how should that assistance be structured? Should it be framed as a direct expenditure, using one or more of the techniques available for that purpose? Or should it be framed as a tax expenditure?

In recent years it has been the fashion to suggest the use of tax incentives or tax credits as solutions to many of our urban and social

problems—pollution control, manpower training of the unskilled and semiskilled, the establishment of new businesses in the inner cities and depressed rural areas, and so on. These tax incentives or credits involve additional tax expenditures. They thus give rise to the difficulties I have described regarding existing tax expenditures. These difficulties, to say the least, would appear to be persuasive reasons militating against the use of tax incentives and credits for such purposes.

Much more could be said on this subject. My only purpose here is to relate current policy problems and issues to the tax expenditure budget.

Recent examples of tax incentives underscore the need for caution and analysis before adding additional tax expenditures. Thus, the legislative committees have struggled long and hard to find the most efficient ways to expend Government resources in the battle against pollution.

There are many claimants for Government dollars, and those concerned about combating pollution have found it difficult to secure the funds they desire. Interested legislators speak of scrounging a few more millions here or there to add to an inadequate budget figure. Yet now, at one stroke, the Ways and Means Committee decides to spend \$400 million (by 1974) in the pollution control area by allowing 5-year tax amortization of the cost of installing pollution control facilities. But the committee does not refer to any study which indicates that—if the Government is to allocate an additional \$400 million to pollution control—the particular device and particular approach chosen by the Ways and Means Committee would have top priority. Instead, \$400 million is allocated to this purpose without any coordination with other planning or expenditures in the pollution control area and without regard to what are the priority needs once it is decided to add \$400 million to pollution control expenditures.

There are other examples in the current tax bill, for example, assistance to housing and to production of railroad cars. Here also many millions of dollars are to be spent through the tax system, again without study, without coordination with other programs, without any determination of the competing priorities for Government funds. This back door, almost haphazard financing, is totally antithetical to efficient and orderly program planning.

CONCLUSION

The tax expenditure budget is a necessary part of the Government's fiscal accounts. It should be published on an annual basis by the Treasury Department and included in the general budget, perhaps as a special analysis. The items in the tax expenditure budget should be carefully studied and cost-benefit analyses made in appropriate cases. Such an approach to the tax expenditure budget and its components is bound to promote greater efficiency in Government and stronger control over expenditures.

(The documents supplementing Mr. Surrey's testimony follows:)

322 1968 REPORT OF THE SECRETARY OF THE TREASURY

Exhibit 29.—Excerpts from remarks by Assistant Secretary Surrey, November 15, 1967, before The Money Marketeers, on the U.S. income tax system—the need for a full accounting; and Treasury Department Report “The Tax Expenditure Budget: A Conceptual Analysis”

EXCERPTS FROM REMARKS BY ASSISTANT SECRETARY SURREY, ON THE U.S. INCOME TAX SYSTEM—THE NEED FOR A FULL ACCOUNTING

An income tax system of such strength and breadth of application [as the U.S. system] warrants a full accounting. It would seem but obvious that we should be fully aware of its content and scope, so that we could intelligently pass judgment on its effects. This being so, it is all the more surprising that there are gaps in the accounting that now obtains. These gaps exist both at the governmental level, in the way our Budget reflects the income tax, and at the level of the individual business, in the way financial accounting handles the impact of the tax. These gaps have serious implications for our understanding of the tax system.

The recent Report of the President's Commission on Budget Concepts seeks to develop one comprehensive measure to reflect aggregate revenues. Its recommendation for the revenue and expenditures part of the budget would include all revenue sources—both general revenues and trust fund revenues—and would place reporting of the income tax revenues on an accrual basis. * * *

The President's Commission on Budget Concepts also made recommendations regarding the budget treatment of expenditures, but one aspect was not considered. The aspect not considered—and this is reflected in all discussions of expenditures—concerns the Government expenditures made through the tax system. At first blush, such a phrase—Government expenditures through a tax system—seems

almost meaningless. A tax system presumably concerns itself with raising revenues rather than spending funds. But a closer analysis of our present tax system would reveal real substance to the phrase. Through deliberate departures from accepted concepts of net income and through various special exemptions, deductions, and credits, our tax system does operate to affect the private economy in ways that are usually accomplished by expenditures—in effect to produce an expenditure system described in tax language.

Let us take a simple example: The Federal budget for the Department of Health, Education, and Welfare has line items detailing expenditures, including trust fund expenditures, for old age assistance. But that budget contains no line item for the \$2.3 billion expended through the tax system to aid the elderly—under the special \$600 exemption, the retirement income credit, the exclusion of social security retirement benefits, and so on. The HEW budget also has line items for medical assistance expenditures, but no line item for \$100 million expended through the tax system by reason of the special exemption for sick pay paid to employees.

The budgets of the Commerce Department and the Transportation Department contain line items for expenditures under Federal programs for aiding business. But there are no line items for the very large amounts, reaching over \$1 billion, expended through the tax system either as tax relief, incentives, or assistance for a variety of business activities: for example, financial institutions, through special deductions for reserves; Western Hemisphere Trade Corporations, through special rate reductions; shipping companies and life insurance companies, through special deferrals.

The budget of the Interior Department has line items for natural resources programs, but no line items for the large amounts, also over a billion dollars, expended under the tax system to assist our natural resources industries, including timber, through expensing of certain capital costs, expensing in excess of cost under the treatment of depletion, and special capital gain treatment. The budget for the Agriculture Department has line items representing programs to assist agricultural activities, but no line items for amounts, over a half-billion, expended under the tax system through the expensing of certain capital costs, the availability of the cash method of accounting even if inventories are used, and special capital gains treatment of livestock.

The absence of line items in the budget for these tax expenditures—this lack of a full accounting for our tax system—has many facets. To begin with, it lessens public understanding of significant segments of our tax policies. For the most part there are no line items in the Internal Revenue Service Statistics of Income delineating these items, so that in the absence of special studies the amounts involved are simply unobtainable. Indeed, many of these "tax expenditure" programs cannot be found in the Internal Revenue Code, so that unlike direct expenditure programs where the budget trails are relatively well posted, the "tax expenditure" trails are very often obscurely marked.

A large part of the tax benefits for the elderly rests on a very brief and cryptic administrative ruling of the Internal Revenue Service excluding social security retirement benefits from income, without citation of any authority for the result; much of the benefits for financial institutions rests on administrative rulings stating how the reserves against debts owed to banks shall be computed; a large part of the benefits to agriculture and natural resources also find their origin and even some of their current expression in administrative rulings and regulations.

When congressional talk and public opinion turn to reduction and control of Federal expenditures, these tax expenditures are never mentioned. Yet it is clear that if these tax amounts were treated as line items on the expenditure side of the budget, they would automatically come under the close scrutiny of the Congress and the Budget Bureau. But the tax expenditures are not so listed, and they are thus automatically excluded from that scrutiny. Instead, since they are phrased in tax language and placed in the Internal Revenue Code, any examination to be given to them must fall in the classification of "tax reform" and not "expenditure control." There is a vast difference between the two classifications.

It can be suggested therefore that we need a full accounting for these effects of the tax system. The approach would be to explore the possibility of describing in the Federal budget the expenditure equivalents of tax benefit provisions. We should not, of course, overlook the difficulties of interpretation or measurement involved here. Thus, just which tax measures can be said to fall in this category—in other words, which tax rules are integral to a tax system in order

324 1968 REPORT OF THE SECRETARY OF THE TREASURY

to provide a balanced tax structure and a proper measurement of net income, and which tax rules represent departures from that net income concept and balanced structure to provide relief, assistance, incentive, or what you will for a particular group or activity. Also, once a tax item can be identified as falling in this second category, we must then compute its expenditure equivalent. Presumably this would be the amount of revenue lost, i.e., "spent," under the special tax treatment, and in a number of situations revenue statistics would have to be improved to give us this information.

This discussion is not to be taken as saying that all tax relief measures are bad—or that all are good—just as it is not intended to state that all Federal expenditure programs are bad or all good. This is not a qualitative discussion of tax preferences or, as some say, tax loopholes.

Nor is my discussion intended to say that tax relief deliberately programed as a direct expenditure item would look the same. Indeed, a possible consequence of describing tax preferences as expenditure equivalents is that more efficient ways to achieve the objective may be developed. I cannot think of any responsible HEW or Budget Bureau official who would put together an expenditure program of assistance to the elderly that would in any way resemble the crazy-quilt pattern of our tax treatment of the elderly. Under that treatment half of the tax revenues spent go to people over age 65 on retirement whose annual income is over \$10,000 and hardly any goes to people in that age group who continue to work for their maintenance and whose incomes are far lower. Nor can I think of an agricultural expert who would put together a farm program under which the benefits would become greater the wealthier the owner and the less he relied on his farm activity as the source of his income. Indeed, I suspect that cost-benefit experts assigned to measure the efficiency of tax expenditure programs would have a fascinating time. Appropriate budgetary recognition of these tax expenditures would facilitate such cost-benefit studies.

At this point a word on the investment credit may be helpful to illustrate a different kind of tax device. This credit is a feature of our tax law designed to improve rates of return and to increase investment. We believe it is a sound provision which serves to achieve a better balance in a tax system which would otherwise impinge too heavily on the level of private savings and investment. Perhaps it could be cast as a direct Government expenditure, and the English have recently taken this approach. But there are very definite advantages in handling the sums involved through the tax system. The computation of the credit depends entirely on tax concepts, such as the basis for depreciation and depreciable lives, and being in the tax system its effect is limited to firms which, at least over the long run, expect to make profits. Also, by being in the tax system it remains quite neutral with regard to the investment to which it is applied; it does not involve extensive Government decisions as to which investments are particularly meritorious. It is spread very broadly over all business, agriculture, finance, the professions, and so on—the whole gamut of American enterprise.

There are thus considerable gaps in the present accounting for our income tax system. It may be helpful to relate this description of these gaps to a current matter—the use of tax incentives to meet our social problems.

America faces many social problems that desperately require solution. A major part of these problems centers around the plight of our cities and their disadvantaged residents. One aspect of suggested solutions involves an increase in moderate and low income housing, with special emphasis on housing located in these areas. Another involves providing jobs for the disadvantaged, through manpower training programs and greater employment in business activity within these areas or the aided movement of the inhabitants to jobs outside the areas. Participation by private enterprise, especially large concerns, is considered helpful to achievement of these goals. But it is said that the likely rate of return from business activity involving that participation may not be adequate to enlist that participation. Hence it is proposed in some quarters that the rate of return be increased by some form of tax reduction in exchange for the participation desired. The tax reduction suggested generally involves a large credit against tax or special deductions.

This is one illustration of the tax incentive approach in the setting of social reform. Other illustrations may be found in other social objectives—pollution control, aid to education, assistance to rural areas, and so on.

Certainly no one can quarrel with these social objectives. In the past tax incentives were generally sought—and at times obtained—on the ground that a particular industry needed support. The crucial question of why that support was in the public interest was barely spelled out, if at all, and the details of proof were held to a minimum. But today the public interest objective is in the forefront, and needs no proving. And it is generally taken for granted that private enterprise participation will always be helpful. What is not shown is why the tax route is to be preferred over other means of inducing the desired participation of private enterprise.

The immediate leap to the tax solution serves only to stultify thinking about these social problems. Once the leap is made there is no opportunity to explore the details of the problems. Yet a great many useful questions can be asked: For example, as to low income housing in urban areas and jobs for the urban disadvantaged, just why has private enterprise not undertaken these tasks in the past? Is it that the immediate return is insufficient, or is it that the participation has been seen as only sporadic? What forms of private enterprise are best suited to the tasks? Is it a large industrial concern or a small indigenous business locally owned; is it manufacturing activity or service activity; is it an experienced builder or a concern new to the building field but with management know-how in other business fields? More crucial, what measures are needed to induce the participation—what rate of profit, what assistance in financing, what guarantees against loss, what assurance of a continued market, what other forms of protection against the risks that have hitherto restrained participation, and so on?

With these questions answered as best we can, the task is then imaginatively to search the arsenal of possible governmental action—if Government assistance is needed—to see which forms of governmental action can be most responsive, effective, and efficient. Here also the immediate leap to the tax route can only prove stultifying, for it tends to foreclose consideration of all other avenues of assistance. And yet experience has taught us that with respect to governmental assistance to a particular group or activity, the nontax route is far more likely to yield the better answer at a lesser cost. Moreover, the tax answer once enacted may well inhibit further useful thought about the problem. It would seem far better to let HUD or Commerce or Labor or HEW gain experience and flexibility through nontax solutions that can be varied and tested, than turn much of the task over to the Internal Revenue Service, which has no background of experience to use and for whom an increase in experience in the social area will not yield the productive return that it would in the other departments.

Our progress in space exploration is not built on tax incentives, but on direct relations between Government and business that bring forth the required participation by private enterprise. Our capsules are not propelled into space by the Internal Revenue Code.

In large part those who leap to the tax route recognize all this. But they assume that the nontax solutions will involve large Government expenditures and they fear that the appropriation door is shut or will not open very wide. Whatever may be the validity of those assumptions and fears as to any particular program, there is no reason to conclude that because the front door of appropriations is closed or narrow, the back door of tax reduction will open wide.

Those who are concerned with the level of Government expenditures are cognizant of the two doors to the Federal budget. They readily understand that a decrease in revenues through a tax expenditure has the same impact on the budget deficit as a direct increase in expenditures. Chairman Mills of the House Ways and Means Committee, for example, has said he considers such tax incentives as "a form of back door spending." He thus fully recognizes it is the door of his committee that is being knocked on as the entrance to the budget through tax incentives, rather than the direct route of Government assistance. And he can also recognize if that door opens for one or two tax incentives, it must inevitably stay permanently ajar for the wave of tax incentives that would follow.

Chairman Mills is on sound ground. For here also we reach the aspect of full and proper accounting. Our experience with the tax incentives of the past should give us pause before we add a new tax-route expenditure and then keep it buried in the Code away from public scrutiny. We have learned that the tax incentive of the moment becomes the tax reform target of many tomorrows. What can be said about tax incentives for these urban problems can also be said about tax incentives for our other social problems—pollution control, college education within the reach of all who are qualified, development of

326 1968 REPORT OF THE SECRETARY OF THE TREASURY

rural areas and new towns, assistance to depressed areas, and so on. It is almost demeaning to our collective wisdom to say that every one of these problems will yield and yield only to the universal solvent of a tax incentive. And if they did, how would we solve the loss of our tax system that this maze of tax incentives would mean?

All of this is not to be taken—and this must be underscored—as saying the Treasury Department stands aloof from society and its problems. The Treasury clearly recognizes that a negative answer as respects the tax route equally does not solve a problem. It therefore has joined—and continually will join—the other departments and agencies in the active search for constructive solutions involving other forms of governmental assistance or action.

Indeed, the Treasury has found that the way to obtain imaginative and broad thinking about these social problems—to obtain real brainstorming—is to tell the groups concerned to forget their stereotype, first impulse solution of a tax incentive, to close the Internal Revenue Code, to bar their tax lawyers from the meeting—and then get down to the real task of analyzing the problems and thinking about the possible solutions. The results are always positive. Once the blinders of a proposed tax incentive solution are removed and the whole horizon of approaches is opened to exploration, we begin to appreciate that there are many constructive measures that can be taken outside of the tax system.

Our social problems are causing very large demands to be made upon the Federal Government. We are a wealthy nation and we certainly should be able to solve these problems. But even with our great wealth the solutions for all these problems will come more readily if our planning is efficient and sound. There are limits to the ways in which we can use our resources and those limits require careful expenditure control. Such control in the planning of a particular program, even one with a high priority, means other useful programs will not have to be starved.

We must therefore recognize that our tax system should not be used as a back door through which the dollars are to flow free from this careful planning. We need a much higher degree of accounting for the dollars that the tax expenditure programs which grew up in the past are now absorbing. We also should be careful not to leap to a new set of uncontrolled tax expenditure programs through a new set of tax incentives. This is especially so when there are adequate nontax measures at hand with which to attack these social problems. As a consequence, closing the back door of tax incentives does not mean that no solution will be provided. Rather, it means that the doors and windows are opened for constructive thinking about these other measures. This is the way to both social progress and a sound tax system.

THE TAX EXPENDITURE BUDGET: A CONCEPTUAL ANALYSIS

Introduction

As every taxpayer knows, income tax laws and regulations are complex. Much of the complexity derives from the numerous deductions, exemptions, credits, and exclusions allowed taxpayers in stipulated circumstances. Many, probably most, of these provisions exist because of the belief that they are directly related to the measurement of net income appropriate to an income tax. But others appear in the tax code because of the belief that, while not required to measure net income, the provision promotes some other objective, such as economic growth or a desirable expenditure pattern by taxpayers. In many areas the influence of the tax code on private economic behavior through these special tax provisions is of an amount which approaches and, in some instances, surpasses that of direct Government expenditures directed to the same objective.

Each of these special tax provisions reduces Government revenues available for other purposes, much as do increases in direct Government expenditures. In most cases, direct expenditures or loan programs exist as alternatives for achieving the same purpose that the special tax provisions are designed to accomplish. Our Federal budget as presently constituted, however, does not report those tax revenues which the Government does not collect because income subject to tax is reduced by these special provisions and the various special credits, deductions, exclusions, and exemptions which they provide. The budget in its present form thus understates the role of Federal Government financial influences on the behavior of individuals and businesses and on income distribution.

As a consequence of these special provisions in the tax system (some provisions are in the statutory tax law and others appear in regulations and rulings), the personal and corporate income tax bases deviate in numerous ways from widely accepted definitions of net income. Numerous kinds of income are excluded from taxation altogether while others are included only in part. Various types of expenditures by households give rise to deductions which are subtracted from income.

These special tax provisions and adjustments have been controversial in varying degree at varying times. In many cases, differences of opinion persist as to whether or not the effects of these deviations on income distribution and resource allocation are desirable. This special analysis is not concerned with the desirability of these provisions. Rather, it lists the major respects in which the current income tax bases deviate from widely accepted definitions of income and standards of business accounting and from the generally accepted structure of an income tax, together with estimates of the amount by which each of these deviations reduces revenues. It also arrays these tax provisions in the functional categories under which direct expenditures are classified in the Federal budget.

The purpose of this analysis is to present information on the basis of which each of these special tax provisions and their revenue cost can be compared with other such provisions which entail a reduction in revenues, and with direct expenditures or loan programs which result in outlays of a similar magnitude. The inclusion of such information, in addition to the ordinary budget accounts, can clarify and present more fully the role of the Federal Government in various functional areas. This information cannot presently be obtained from either the budget documents or the Statistics of Income published by the Internal Revenue Service.

It is useful periodically to review the impact on revenues of special tax provisions, much as direct expenditures are subject to annual or periodic review, since these impacts may change quite substantially over time. The amount of the revenue loss from the various provisions varies with changes in the economy and in tax rates. And the importance and priority of the objectives of the various special tax provisions change over time.

The use of a specific tax provision to support or subsidize a particular industry or economic activity may be a relatively inefficient or costly method to accomplish the objective, compared to a direct expenditure, the net cost of a loan program, or alternative tax provisions. In other words, the ratio of benefits to costs might be more favorable under an expenditure or loan program than by means of a special tax provision, or it might not. If these provisions, however, are not reviewed periodically to measure the benefits they achieve against the revenue loss, ineffective and outdated provisions may remain in the tax law for years.

In recent years there has been growing interest in improving program planning and evaluation by examining efficiency and effectiveness in expenditure examining programs. The technique of program budgeting has been given Government-wide application following an Executive order by President Johnson. In the fiscal year 1967 budget message (page 33), the President enumerated several basic steps directing the executive branch to develop and introduce a new planning-programming-budgeting system which will accomplish the following:

- “Be more concrete and precise about the objectives of our programs.
- Examine longer term problems and consequences more systematically.
- Consider more alternatives before reaching decisions.
- Link our planning efforts more directly to budget decisions.
- Get more effectiveness for the dollars we spend.
- Provide more benefits to the American people in more economical ways.”

Also, in his 1966 “Economic Report” (page 18), the President in discussing criteria for taxation referred to the need to apply the efficiency test to taxation, recognizing that tax provisions can also represent Government costs:

“In a fully employed economy, special tax benefits to stimulate some activities or investments mean that we will have less of other activities. Benefits that the Government extends through direct expenditures are periodically reviewed and often altered in the budget-appropriation process, but too little attention is given to reviewing particular tax benefits. These benefits, like all other activities of Government, must stand up to the tests of efficiency and fairness.”

Conceptual framework

The special tax provisions take many forms. Under some, certain types of income are excluded from taxation, a few examples being interest on State and local gov-

328 1968 REPORT OF THE SECRETARY OF THE TREASURY

ernment bonds, half of realized long term capital gains, social security benefits to the aged, and employer payments for fringe benefits, such as hospitalization, surgical, and group life insurance premiums. Other special tax provisions are in the form of deductions for certain personal expenses, such as charitable contributions, medical expenses, and interest payments. Other special deduction provisions allow business expenditures in excess of actual cost (percentage depletion, certain bad debt reserves) or earlier in time than the cost would become an expense under business accounting (agriculture, research and development, exploration and discovery of natural resources). Other special provisions provide a lower effective tax rate than is generally applicable, such as the lower statutory rate on Western Hemisphere Trade Corporations and the lower ceiling rate on long-term capital gains. Still other provisions take the form of tax credits (retirement income credit, investment credit).

Most of these special tax provisions are designed expressly to achieve objectives similar in nature to those of direct Government expenditures or loan programs. In each functional area, the Federal budget includes direct Government expenditures, direct Government loans, loans insured by the Government, and loan subsidies which have similar though perhaps not identical objectives. In each of these areas, such direct spending or loan programs would be an alternative method to accomplish the purpose which the special tax provision seeks to achieve or encourage.

We can examine several of these tax provisions to indicate how "tax expenditures" are alternatives to direct expenditures or Government lending programs. As a first illustration, consider the provisions which benefit the aged. The Federal budget lists under the functional category of "health, labor, and welfare" large direct expenditures including the social security and medicare trust funds for the aged. But the budget contains no item to show the \$2.3 billion expended through the tax system to aid the elderly through the retirement income credit, the additional \$600 exemption, and the exclusion of social security retirement benefits. The same assistance could be achieved by additional transfer payments to the aged rather than by tax provisions.

As another illustration, commerce and transportation shows almost \$8 billion of direct expenditures and net lending for fiscal year 1968. However, the budget does not reveal the additional amounts which aid business through various tax relief, tax incentive, and other tax provisions. These special provisions assist a variety of business activities, for example, financial institutions through special deductions for bad debt reserves, which reduce income subject to tax; Western Hemisphere Trade Corporations through special rate reductions; shipping companies through special deferrals; firms making new investments in machinery and equipment through the investment credit; small business through the lower rate on the first \$25,000 of taxable income and more generous depreciation deductions. Direct expenditures could be designed as substitutes for these tax expenditures. For example, "investment grants" could be paid to firms undertaking new investments, in place of the "investment tax credit."

Direct expenditures for natural resources, as another example, are itemized in the budget but no items are presented to cost out the assistance the tax system provides these industries by permitting the expensing of certain capital costs, the use of percentage depletion in excess of cost depletion, and special capital gains treatment for timber and for iron ore and coal royalties. Direct expenditures could be tailored to achieve the same purpose as these expenditures through the tax system. For example, subsidies might be paid to encourage exploration and development of selected minerals or good forest management.

In the field of housing, one of the major tax expenditures is the deduction allowed for interest paid on home mortgages, which now costs the Government about \$1.9 billion annually in income tax receipts foregone. The Government now provides direct subsidies to lower the interest rates on mortgages paid by buyers of certain homes. Such direct interest subsidy payments could be increased and broadened to achieve the same goal as the tax provisions. Alternatively, Federal programs to guarantee or insure mortgages on homes or to make direct loans could be expanded as an alternative to deductibility of mortgage interest for tax purposes.

The recommendations of the President's Commission on Budget Concepts provided that in the unified budget direct expenditures, credit programs, and the discounted present value of loan or interest subsidies should be included on the outlay side. These changes represent significant improvements in making

the budget a more comprehensive and useful presentation. To complete the budget picture, however, the Government expenditures made through the tax system need to be taken into account. Since these tax expenditures serve ends similar to those which are, or might be, served by direct expenditure programs or loan programs, it would be appropriate and instructive to juxtapose the tax provisions and the revenue costs they involve with the expenditures in the same functional category in order to understand better the purpose to which public resources are allocated. This study provides such a classification of tax expenditures together with estimates of the amounts involved. It treats the revenues "lost" through the special tax provisions as the cost of the tax expenditures involved.

Some of the special tax provisions cost revenue which is lost to the Government forever, resulting from those exclusions, exemptions, deductions, credits, or preferential rates which reduce the current tax base or the tax rates without any offsetting increase in the tax base later. Such provisions provide tax expenditures which correspond closely to direct expenditures.

Other special tax provisions serve immediately to defer the time when the taxes will be paid. For a particular taxpayer or a particular transaction or asset, the special provision may really represent a deferral of tax. However, for stable or growing businesses with an indefinite life, for the U.S. Government, and for the entire economy, the deferral of taxes continues forever under most of these provisions; in addition in an expanding economy the aggregate amount of deferred taxes tends to grow year after year. Examples of special tax provisions which cause deferral of taxes from the viewpoint of the individual taxpayers include: employer contributions to private pension plans and investment income of such plans; deductions of funds set aside by self-employed persons for their pensions; accelerated depreciation deductions on particular buildings; the portion of net income reinvested in ship construction and renovation by certain shipping companies; expensing of capital costs in agriculture and natural resource industries; expensing of research and development expenditures; and exclusion of nonrepatriated earnings of foreign subsidiaries.

Special tax provisions, which serve to defer but not forgive tax payments, might be compared to net lending in budget terminology. From the Government's view, the deferrals in the aggregate are for the indefinite future, perhaps permanently, depending in large part on the level and composition of economic activity. These special tax provisions are generally open-ended, with the extent and duration of their use largely at the taxpayers' option. For these reasons, the tax expenditure classification and tables which follow do not separate the special provisions which reduce taxes from those which defer taxes.

The study does not attempt a complete listing of all the tax provisions which vary from a strict definition of net income. Various items that could have been added have been excluded for one or more of several reasons:

(a) Some items were excluded where there is no available indication of the precise magnitude of the implicit subsidy. This is the case, for example, with depreciation on machinery and equipment where the accelerated tax methods may provide an allowance beyond that appropriate to the measurement of net income but where it is difficult to measure that difference because the true economic deterioration or obsolescence factor cannot be readily determined.

(b) Some items were excluded where the case for their inclusion in the income base stands on relatively technical or theoretical tax arguments. This is the case, for example, with the imputed rent on owner-occupied homes, which involves not only a conceptual problem but difficult practical problems such as those of measurement.

(c) Some items were omitted because of their relatively small quantitative importance.

Other features of our income tax system are considered not as variations from the generally accepted measure of net income or as tax preference but as a part of the structure of an income tax system based on ability to pay. Such features include personal exemptions and the rate schedules under the individual income tax, including the income splitting allowed for married couples filing joint returns or for heads of households. A discussion of income splitting and the dependent's personal exemption is thus considered outside the scope of this study on tax expenditures.

It must be recognized that these exclusions are to some extent arbitrary and some may prefer to add items that we have omitted or to omit items that we have

330 1968 REPORT OF THE SECRETARY OF THE TREASURY

included. The immediate objective, however, of the study is to provide a list of items that would be generally recognized as more or less intended use of the tax system to achieve results commonly obtained by Government expenditures. The design of the list seemed best served by constructing what seemed a minimum list rather than including highly complicated or controversial items that would becloud the utility of this special analysis.

An estimate of revenue cost is given for these special tax provisions. The estimate is for fiscal year 1968, to allow a comparison with the budget expenditures and net lending for that year.¹ All estimates are for revenues "lost" on an annual basis.

The estimates of revenue foregone because of the tax expenditure features of the present tax law are, in general, based on the assumption for estimating purposes that such provisions never existed.

Another key assumption is that economic activity in 1967-68 would not have been affected by the absence of these special provisions. This, of course, is a simplifying assumption as it is practically impossible to estimate how the economy would have performed in the absence of all these tax provisions. In the absence of these tax benefits, no doubt there would be changes in Government direct spending and net lending to accomplish some of the objectives of the existing provisions.

No account is taken here of other taxes, such as payroll taxes, estate and gift taxes, excises, or tariffs. The assumption inherent in current law, that corporations are separate entities and subject to income taxation independently from their shareholders, is adhered to in this analysis.

Tax expenditures—by functional category

We now turn to a rundown of the various special tax provisions, listing them under the sequence of expenditure categories used in the Federal budget. Some items, such as deductions for medical expenses, fit clearly under one functional heading (health, labor, and welfare). Other provisions, such as the lower tax rate on the first \$25,000 of corporate income, might be classified under or divided between two or more functional headings (such as agriculture, natural resources, commerce and transportation). In the following discussion, each special tax provision is placed under only one heading (commerce and transportation, for this last mentioned tax provision).

A summary of the estimated dollar amounts of the special tax provisions by functional categories is presented in table I. The grouping of all the special tax provisions by the various functional categories in the budget is shown in table II.

1. National defense

Exclusion of benefits and allowances to Armed Forces personnel.—The Armed Forces supplement salaries of military personnel by providing quarters and meals on military bases, and off-base quarters allowances for military families; these items are not included in taxable income. In addition, virtually all salary payments and reenlistment bonuses to military personnel serving in combat zones are excluded from tax. The revenue cost is \$500 million. (As indicated earlier, all revenue costs are estimated on annual amounts for fiscal year 1968.)

¹ The revenue cost estimated for these special provisions is not in many cases the revenue change which would result in the first full year if these provisions were withdrawn. For one thing, replacement of some or all of these provisions by direct expenditures or lending programs might change the level and composition of economic activity. The revenue costs as presented for 1968 would, of course, vary over time generally with growth in the economy and changes in various parts of the tax base.

Also a realistic approach to any change in these provisions would provide in many situations transition arrangements which would effect the revenue change gradually over a period of years. Most of the tax provisions discussed here have been in the law for a number of years. Individuals and businesses have planned their activities in many ways to fit present law, such as compensation contracts, estate planning, corporate financing, and forms of business organization. A shift to direct expenditures or loan programs would usually not be a complete and full substitute for the specific taxpayers for the tax provision withdrawn. Thus, changes in special tax provisions would often provide transition rules, deferred effective dates, application to prospective events only, and other means for an equitable changeover to a new tax situation.

All the revenue estimates exclude the 10-percent surcharge, none of which was collected in fiscal year 1968.

2. International affairs and finance¹

a. *Individual taxation.*—For citizens of the United States, income earned abroad up to \$20,000 for each complete tax year is exempted from taxation if the taxpayer is a bona fide resident of a foreign country for an uninterrupted period that includes 1 full tax year or, if he is present there 510 days during a period of 18 consecutive months. After 3 years, foreign resident taxpayers can exclude up to \$25,000 a tax year. The revenue cost is \$40 million.

U.S. citizens receiving income from sources in a U.S. possession may, under certain conditions, exclude such income from tax. The revenue cost is \$10 million.

b. *Corporate taxation.*—Domestic corporations conducting all of their business activities (other than incidental purchases) in the Western Hemisphere, deriving at least 95 percent of gross income from sources outside of the United States and at least 90 percent from the active conduct of a trade or a business qualify as Western Hemisphere Trade Corporations entitled to a special deduction. The net effect of this deduction is to reduce the eligible corporation's tax rate by 14 percentage points. The revenue cost is \$50 million.

Income of foreign branches and subsidiaries of U.S. corporations is subject to taxation abroad. Foreign branch profits are subject to U.S. taxes in the year earned. Profits of foreign subsidiaries are generally not taxable in the United States until they are repatriated as dividends to U.S. taxpayers. Domestic corporations receiving dividends from foreign subsidiaries may take a credit for foreign income taxes levied on the profits of the foreign subsidiaries out of which the dividends were paid. If the dividends are from a foreign subsidiary in an industrialized country (i.e., one other than a "less-developed country" as defined in the Internal Revenue Code), the domestic corporation must "gross up" the dividends to include in taxable income the amount of tax paid by the foreign corporation for which credit is claimed. In other words, the tax base in such a case is income before deduction of income taxes. On the other hand, if dividends are received from a subsidiary in a less-developed country, "grossing-up" is not required. Consequently, a domestic parent company secures the benefit both of a deduction of foreign income taxes (since dividends are after taxes) and a credit for foreign income taxes. The revenue cost of not requiring the "gross up" of dividends from less-developed country corporations is \$50 million.

U.S. corporations are not required currently to file consolidated returns which include the unrepatriated earnings of controlled foreign subsidiaries. The revenue cost of excluding these earnings is \$150 million.

Domestic corporations deriving the bulk of their income in U.S. possessions may, under certain conditions, exclude such income from tax. The revenue cost is \$70 million.

3. Agriculture and agricultural resources

Farmers, including corporations, may deduct certain costs as current expenses even though these costs represent inventories on hand at the end of the year or capital improvements. For example, the cost of producing crops or raising livestock not sold at the end of the tax year may be deducted as an expense even though no revenue has been earned. Certain capital improvement costs, such

¹ The foreign tax credit represents a special problem. Ultimately it arises from an international convention, which the United States has accepted, that income earned in one country by a citizen or corporation of another country should first be taxed by the country where earned and this tax should be recognized in some fashion, as by a tax credit by the country of citizenship or incorporation. (The U.S. law refers to citizens and residents; the law in other countries refers only to residents.) This convention precludes or limits the effects of taxing income twice as well as specifying the order of the taxes.

The order of the two taxes may be logically debatable despite the general convention. The U.S. share of taxes on international operations would be higher if the convention were to tax in the country of citizenship or incorporation first with a tax credit in the country where earned. Also one could argue that the scope of the foreign tax credit under present U.S. law differed from a logical foreign tax credit in various respects, such as extension to questionable income taxes or use of the overall limitation. These features of the foreign tax credit could result in identifying it as partly equivalent to a tax expenditure.

Another point of view is that the foreign tax credit per se is in total equivalent to a tax expenditure, since the credit can be considered as a removal of a barrier to foreign operations by U.S. businesses. Due to the complexity of the issues involved this study does not make any estimate of the part that could be called a tax expenditure, except as respects the absence of "gross-up" for dividends from less-developed country corporations stated in the text.

332 1968 REPORT OF THE SECRETARY OF THE TREASURY

as the costs of preparing land and diversion of streams, are deductible during the year incurred rather than capitalized and depreciated.

Gains from the sale of draft, breeding, or dairy livestock held for 12 months or more are taxed as long-term capital gains rather than ordinary income although the costs of raising these animals are considered operating expenses and may therefore be deducted from ordinary income. Capital gain treatment also extends to the sale of orchards, vineyards, and comparable agricultural activities.

The revenue cost of this treatment is \$800 million.

The "gain" on the "cutting" of timber is taxed at the rates applicable to long-term capital gains, rather than at ordinary income rates. The revenue cost is \$130 million.

4. Natural resources

Certain capital costs necessary to bring a mineral deposit into production may be deducted as current expenses rather than spread over the useful life of the property. Included in this category are the "intangible drilling costs" of oil or gas wells and the costs of developing other mineral deposits, such as mine shafts, tunnels, and stripping. The revenue cost is \$300 million.

Extractive industries may choose between two methods of recovering capital costs invested in the development of natural resources. Under one method, such outlays to the extent not immediately expensible may be deducted as "cost depletion" over the productive life of the property, much as other businesses may take deductions for the depreciation of capital goods. Alternatively, businesses in the extractive industries may deduct a flat percentage of gross income (but not more than 50 percent of net income) where such "percentage depletion" exceeds "cost depletion." Percentage depletion is not limited to the cost of the investment as is cost depletion. Cost for cost depletion means costs which have not already been recovered through expensing of exploration and discovery costs and intangible drilling costs. The fraction of gross income deductible under percentage depletion varies, with statutory rates ranging from 27.5 percent for oil and gas to 5 percent for certain minerals. The revenue cost is \$1.3 billion.¹

Royalties from coal or iron ore deposits are treated as capital gains. The revenue cost is \$5 million.

5. Commerce and transportation

There exist a variety of tax provisions which cause tax liabilities of businesses to be lower than they would be in the absence of the provisions.

a. *Investment credit.*—Under the investment tax credit most businesses may deduct from their tax liability an amount equal to 7 percent of the cost of investments in new machinery and equipment made during the taxable year. This investment credit does not lower the basis of the property for calculating the deduction for depreciation. The revenue cost is \$2.3 billion.

b. *Excess depreciation on buildings.*—To the extent that allowable depreciation for tax purposes exceeds the rate at which assets actually depreciate, business tax liabilities are deferred. Businesses may employ a variety of depreciation schedules for tax purposes, some of which cause a much larger part of asset values to be written off in early years of the asset's useful life than do others. These tax schedules differ from the depreciation schedules used by businesses in their financial statements. The revenue cost of allowing, for buildings only, depreciation methods for tax purposes that reduce asset value more rapidly than straight line depreciation (the method typically used in financial statements) is \$750 million,² of which \$250 million appears under housing and community development.

¹ In the absence of the expensing of exploration and development costs and percentage depletion, the first year revenue effect would be \$750 million and \$1.5 billion, respectively. The difference from the text estimates, which are based on long-run effect, is due to the circumstance that taxpayers with mineral properties would initially have little or no tax basis because of deductions in prior years.

² This difference for a particular asset would narrow over time since depreciation taken during the early years of an asset's life cannot be taken during later years of the asset's life. However, for all depreciable assets together, with investment rising in an expanding economy, the difference between deductions under tax depreciation and under straight-line depreciation will increase in line with the rate at which investment expanded.

The tax depreciation allowed for machinery and equipment is thought to be closer to actual depreciation than that allowed on buildings. Also the code provisions relative to recapture of profits resulting from excess depreciation effects a full recapture as ordinary income of such profits on machinery and equipment, but recapture of only a declining and then disappearing proportion of such profits in the case of buildings. In view of this and the difficulty of estimating the divergence, if any, between depreciation allowed for tax purposes and actual depreciation, depreciation for machinery and equipment is not included here as a tax expenditure.

c. *Dividend exclusion*.—Individual income taxpayers may exclude \$100 of dividends from income subject to tax. The revenue cost is \$225 million.

d. *Capital gains—individual income tax*.—If the owner of appreciated capital assets dies, the capital gains tax is not applied to appreciation which would have been taxable had he sold the assets just before death. Heirs who receive appreciated property from the decedent and who subsequently sell the property are subject to capital gains tax only on appreciation occurring after they acquired the property. Thus the appreciation on assets held until death is never taxed under the income tax. The revenue cost of this treatment is \$2.5 billion.

As to realized gains, half of the gains from the sale of capital assets held more than 6 months is excluded from income, and in no case is the tax rate applicable to such capital gains allowed to exceed 25 percent. The revenue cost of this treatment is \$4.5 billion. The revenue cost of this treatment for both realized gains and gains at death is \$8.5 billion (including the \$2.5 billion listed above).

The cost of capital gain treatment under present law is complex for a number of reasons. It could be contended that:

1. full taxation of realized capital gains, even with full taxation at death, could result in greater postponement of lifetime gains;

2. with a different treatment of capital gains another approach to the corporate tax might provide for some integration of corporate and individual taxes by giving taxpayers who sell corporate shares some credit for taxes paid by the corporation on retained income which is reflected in share values;

3. averaging of capital gains would lower the indicated revenue cost.

Arbitrarily the cost of the present treatment of capital gains is shown as a range of \$5.5 billion to \$8.5 billion to recognize the complex issues involved.

e. *Capital gains—corporation income tax*.—Corporations are subject to a tax of 25 percent on capital gains, while the rate applicable to other corporate income is 48 percent of the excess of income over \$25,000. The revenue cost is \$500 million.¹

f. *Bad debt reserves of banks and other financial institutions*.—Businesses are generally authorized to deduct as ordinary business expenses additions to reserves for bad debts where such reserves reflect historical experience of the firm or reasonable anticipations about the future. Commercial banks, mutual savings banks, building and loan associations, and cooperative banks, however, are permitted to set aside bad debt reserves based on stipulated fractions of deposits, of loans outstanding, or of taxable income before computation for bad debts. These special bad debt reserves typically greatly exceed actual loss experience. The revenue cost is \$600 million.

g. *Credit unions*.—Credit unions are exempt from Federal income tax. The revenue cost is \$40 million.

h. *Deduction of interest on consumer credit*.²—Interest paid on consumer credit is allowed as an itemized nonbusiness deduction for individuals. The revenue cost is \$1.3 billion.

i. *Expensing of research and development expenditures*.—Expenditures by businesses for research and development (R&D) are carried out to find new products or processes, to reduce costs, or for other purposes. In nearly all cases, benefits from such expenditures will accrue for well over 1 year. For tax purposes businesses may deduct all R&D expenditures in the year during which they are incurred, or they may amortize them over not less than 5 years. The revenue cost of current deduction compared to amortization over 5 years is \$500 million.

j. *\$25,000 surtax exemption*.—Corporations pay income tax at the rate of 22 percent on all taxable income plus a surtax of 26 percent on taxable income in excess of \$25,000. Each corporation therefore enjoys a surtax exemption of \$25,000. This exemption is intended to encourage small or new businesses. The revenue cost of this exemption is \$1.8 billion.

In some instances, a number of branch stores or chains are separately incorporated but are controlled by one parent corporation or individual. Each of the multiple corporations receives a surtax exemption. The revenue cost of this multiple surtax exemption compared with allowance of one exemption of \$25,000 for

¹ This cost does not include the cost of capital gain treatment listed under agriculture and natural resources.

² The deduction for interest on debts related to the production of income is a business deduction, appropriate as a deduction to obtain a net income measure. Deductions for interest for business purposes, such as operation of a farm or business or relative to personal investing, are thus not included as a tax expenditure item.

334 1968 REPORT OF THE SECRETARY OF THE TREASURY

the corporate group is \$225 million. (This revenue cost is included in the above estimate of the revenue cost for the entire surtax exemption.)

k. *Deferral of tax on shipping companies.*—Certain companies which operate U.S. flag vessels on foreign trade routes receive an indefinite deferral of income taxes on that portion of their net income which is used for shipping purposes, primarily construction, modernization, and major repairs of ships. The revenue cost is \$10 million.¹

6. Housing and community development

Owner occupants of homes may deduct mortgage interest and property taxes (but not maintenance outlays or depreciation) as itemized nonbusiness deductions. The revenue cost of deductions for interest paid by homeowners on the mortgages on their homes is \$1.9 billion.² The revenue cost of deductions for property taxes paid by homeowners is \$1.8 billion. The revenue cost of depreciation on rental housing is \$250 million. (See 5b above.)

7. Health, labor, and welfare

A large variety of direct expenditures and transfer payments are undertaken to contribute to the improvement of the health and welfare of families and individuals, both currently and in later years. A considerable number of special tax provisions serve related ends. The major tax provisions are listed below, with exclusions and exemptions first, followed by deductions.

a. *Provisions relating to the aged, blind, and disabled.*—Individual taxpayers age 65 and over may claim two personal exemptions of \$600 and a second \$100 minimum standard deduction (while persons under age 65 may claim only one of each). The revenue cost of these additional items is \$500 million.

Aged recipients of old age, survivors, and health benefits under the OASDHI program and of railroad retirement benefits are not required to include such benefits in computing tax liability. The revenue cost of this exclusion is \$25 million.³

Individuals over age 65 may claim a tax credit of up to \$228.60 (\$342.90 for couples) based on retirement income from all sources except social security benefits. In effect, the provision permits taxpayers with retirement income to exclude from taxable income the difference between \$1,524 (\$2,286 for couples) and any social security benefits they receive; the credit does not extend to wage income. The revenue cost of the retirement income credit is \$200 million.

The combined revenue cost of the three provisions just enumerated is \$2.3 billion. The joint revenue cost exceeds the sum of the three measures taken separately, since the absence of one provision would increase the residual significance of the others.

The blind qualify for two \$600 personal exemptions and an extra \$100 minimum standard deduction. The revenue cost is \$10 million.

b. *"Sick pay" exclusions.*—Certain payments financed by an employer in lieu of wages during periods of employee injury or sickness are excluded from the employee's income. The revenue cost is \$85 million.

c. *Exclusion of unemployment insurance benefits.*—Benefits paid by State unemployment insurance plans are excluded from taxable income. These benefits are financed by a tax on wages which is deductible to the employer. The revenue cost of the exclusion of these benefits is \$300 million.

d. *Exclusion of workmen's compensation benefits.*—Benefits paid under workmen's compensation following a work-related personal injury or sickness are excluded from taxable income. (These payments are primarily intended to replace earnings lost due to a work-related injury or illness, although some small part of the total payments is compensation for physical loss, such as an eye or an arm.)

¹ The revenue cost of the special treatment for controlled foreign subsidiaries engaged in shipping operations is included in the general cost of exclusion of income of controlled foreign subsidiaries listed under international affairs and finance.

² In general, we cannot trace borrowed funds precisely and thus the allocation of the revenue cost of the nonbusiness interest deduction between housing and community development and commerce and transportation is somewhat arbitrary. The fact that borrowing takes the form of a home mortgage does not always mean that the purpose of the mortgage is to finance the purchase of the home. Individuals may find their homes provide a type of collateral to secure a loan on more advantageous terms than with other or no collateral, even though the purpose of the loan may be to finance something else, such as a child's college education, medical bills, or a vacation. On the other hand, some other consumer nonbusiness borrowing may be done to enable a family to make a down payment on a home or finance major home repairs, without borrowing under a mortgage.

³ This revenue estimate is based on treatment comparable to other pensions, and regards one quarter of the benefits as approximately the cost of employee contribution.

The employers' payments for workmen's compensation insurance are deductible in computing the employers' income subject to tax. The revenue cost of the exclusion is \$150 million.

e. *Exclusion of public assistance.*—Public assistance payments are excluded from taxable income. The revenue cost is \$50 million.

f. *Certain exclusions for pensions*

(1) *For employees.*—Employer contributions to qualified employee pension and annuity plans are deductible to the employer. Income earned by qualified pension and annuity plans on their investments, from both employer contributions and employee contributions, is not taxable. When a pension or annuity is paid upon the retirement of the employee, the pension or annuity is taxable to the employee except as to the percentage of the benefit purchased by his contributions, not counting in the latter interest earned on his contributions.

The revenue cost of the exclusion of investment income earned by all private pension funds, based on the corporate tax rate, is \$1.9 billion. The revenue cost of deduction of the total amount contributed by employers to these qualified plans, based on the corporate tax rate, is \$3.4 billion.

The revenue cost, based on the individual income tax rates applicable to employees, is \$0.7 billion as respects the investment income and \$1.4 billion as respects the employers' contributions.

The greater the extent to which the benefits are vested, the more relevant is the use of the individual tax rate in estimating the revenue cost. Taking this vesting into account, the revenue cost of the treatment of pension plans can be put at \$3.0 billion.

(2) *For self-employed persons.*—Self-employed individuals are permitted a deduction from taxable income for funds they set aside currently in qualified retirement plans. The deduction is limited to 10 percent of earned income or \$2,500, whichever is less. When the pension or annuity benefits are received after retirement, that percentage of benefits purchased out of tax-free income is subject to tax. The revenue cost of this deduction is \$60 million.¹

g. *Exclusion of other employee benefits.*—In addition to the benefits already enumerated, a number of other employee benefits, the cost of which is paid at least in part by the employer, are also excluded from income subject to tax. The cost to the employer is deductible, and the benefit to the employee not taxable, in all of these cases. A list of these exclusions follows, with the revenue cost associated with each item:

	<i>In millions</i>
1. Premiums on group term life insurance (up to \$50,000 of coverage) -----	\$400
2. Employee death and accident benefits (up to \$5,000) -----	25
3. Premiums paid to qualified plans for hospitalization, surgical, and other medical care -----	1, 100
4. Reserve buildup under privately financed supplementary unemployment benefit plans -----	25
5. Meals and lodging -----	150
Total -----	1, 700

h. *Exclusion of interest on life insurance savings.*—Life insurance policies, other than term policies, generally have a savings element in them. Savings in the form of policyholders' reserves are accumulated from the premium payment and interest is earned on these policyholders' reserves. Such interest income is not taxable as it accrues and it is not taxable as an element of death benefits. The interest income, however, is taxable to the extent that the proceeds exceed net premiums when insurance is paid for causes other than death. The revenue cost of the interest exclusion is \$900 million.

i. *Deductibility of contributions for other than education.*²—Contributions to most nonprofit organizations devoted to charitable, religious, or certain other activities are allowed as an itemized nonbusiness deduction for individuals. The deduction is generally limited to 30 percent of adjusted gross income for contributions to organizations supported by the general public. Unlimited contributions may be deducted by those taxpayers (a relatively small number) whose contributions plus income taxes equal 90 percent of taxable income in eight out of the preceding 10 years.

¹ This estimate is based on the rules made applicable starting in 1968.

² Contributions for education are listed in the next section under the budget heading for education.

336 1968 REPORT OF THE SECRETARY OF THE TREASURY

The revenue cost of the deduction for contributions for other than education is \$2.2 billion, of which \$1.2 billion is attributable to contributions to religious organizations and \$1.0 billion to contributions to other noneducational organizations.¹

Taxpayers who contribute to charitable or educational organizations capital assets, usually securities, which have appreciated in value above their cost, obtain a deduction for the contribution at the appreciated value of the asset without taxation on the appreciation in value. The revenue cost of the deduction for such charitable contributions is included in the estimate just given. The revenue cost of the exclusion of the appreciation in value of the donated property is \$100 million.

j. Deductibility of medical expenses.—Medical expenses in excess of 3 percent of adjusted gross income and expenditures for prescribed drugs and medicines in excess of 1 percent of adjusted gross income may be deducted by individuals as itemized nonbusiness deductions. In effect, the deduction is permitted for those medical expenses above a floor based on percentage of income to cushion the effect of relatively large medical expenses not covered by insurance. Individuals may also deduct half of the premiums paid for medical care insurance up to a maximum deduction of \$150 per year, without regard to the 3 percent limitation. The revenue cost of both these deductions is \$1.5 billion.

k. Deductibility of child and dependent care expenses.—Deductions for a limited amount of expenditures for the care of children under 13 or incapacitated dependents necessary to enable the taxpayer to work are permitted under certain circumstances. If adjusted gross income of a family is \$6,000 or less, child care expenses may be deducted up to \$600 for one child, or \$900 for two or more children. The deduction is reduced, when both parents are in the home and able bodied, by the amount the combined income of husband and wife exceeds \$6,000. The revenue cost is \$25 million.

l. Deductibility of casualty losses.—Taxpayers may deduct as an itemized nonbusiness deduction the amount in excess of \$100 for each loss due to fire, theft, or other casualty to the extent not compensated by insurance. The revenue cost is \$70 million.

m. Standard deductions.—Individuals may itemize personal deductions for certain nonbusiness expenditures, such as charitable contributions, certain State and local taxes, interest payments on home mortgages and consumer credit, child care expenses, medical and drug expenses above a stated percent of income and casualty losses—items referred to earlier in this listing. The taxpayer is also given the option to deduct—instead of this itemization—a standard deduction of 10 percent of adjusted gross income or \$1,000 (\$500 if married and filing separately), whichever is less. The revenue cost of the 10 percent standard deduction is \$3.2 billion.

8. Education

a. Additional personal exemption for students.—Taxpayers may claim personal exemptions for dependent children over 18 who receive \$600 or more of income per year only if they are full-time students. The student may also claim an exemption on his own tax return, in effect providing a double exemption, one for the parents and one for the student. The revenue cost is \$500 million.

b. Deductibility of contributions to educational institutions.—Contributions to nonprofit educational institutions are allowed as an itemized nonbusiness deduction for individuals. The deduction is generally limited to 30 percent of adjusted

¹ The revenue cost of the unlimited contributions deduction, taking into account educational as well as other charitable contributions, is \$45 million. This amount is included in the revenue cost given in the text for contributions to charitable and educational organizations.

Corporations may take deductions for contributions to both charitable organizations and educational institutions. The revenue cost is \$400 million. In the absence of deductibility of contributions, however, presumably some of these would be treated as business expenses and thus this amount is not included as a tax expenditure.

² In the absence of the 10 percent standard deduction and most itemized nonbusiness deductions, the minimum standard deduction as presently structured would be taken by all taxpayers and its revenue cost would be relatively large. Under present treatment, the minimum standard deduction in keeping with its objectives is claimed almost entirely by low-income taxpayers and its revenue cost is \$300 million. The revenue estimate in the text assumes the minimum standard deduction is designed to assist only low-income taxpayers.

The minimum standard deduction is regarded as related in this study to the system of personal exemptions and thus a part of the structure of an income tax system based on ability to pay, rather than as a tax expenditure. (See "Introduction".)

gross income for contributions to organizations, including educational institutions, supported by the general public. The revenue cost is \$170 million.¹

c. *Exclusion of scholarships and fellowships.*—Recipients of scholarships and fellowships may exclude such amounts from taxable income, subject to certain limitations. The revenue cost is \$50 million.

9. Veterans' benefits and services

Veterans receive benefits under a number of programs providing for transfer payments, direct provision of services, and special access to credit. Veterans' pensions exclusive of retirement pay based on age or length of service are excluded from taxable income. The nontaxable payments include all pensions paid due to disability and all pensions paid by the Veterans' Administration to veterans over 65. The revenue cost is \$550 million.

10. Aid to State and local government financing

The Federal Government through certain tax provisions in effect provides assistance to State and local governments. The deductibility of property taxes on owner-occupied homes involving a revenue cost of \$1.8 billion was listed above under housing and community development as an element of the tax system which provides support to promote housing, similar in many respects to certain direct expenditures and loan programs. This provision also aids States and, particularly, local governments in imposing taxes to finance their expenditure programs. Two other special tax provisions also aid State and local governments in meeting their expenditure commitments, but, unlike the deductibility of property taxes on homes, they do not fit clearly within any of the present functional categories now used in describing the scope of Federal budget expenditures. Thus we have added aid to State and local government financing as a separate budgetary heading, although there is no comparable heading in the Federal budget.

Interest income paid by State and local governments on debt obligations to individuals, businesses, and fiduciaries is not subject to tax under the Federal individual or corporate income taxes. As a result of the exclusion of such income from tax, State and local governments are able to sell debt obligations at a lower interest cost than could be possible if such interest were subject to tax. The revenue cost is \$1.8 billion.

Under the Federal income tax, individuals may take as itemized nonbusiness deductions State and local personal income, gasoline, sales, property, and other taxes in calculating income subject to tax. The deductibility of all these State and local taxes (excluding property taxes on owner-occupied homes) on nonbusiness returns² can be classified as support for the finances of State and local governments, rather than listed under any of the functional categories in the current budget. The revenue cost of these deductions is \$2.8 billion.³

¹ Corporations may take deductions for contributions to educational institutions, the revenue cost of which is included in the \$400 million for all corporate contributions in footnote 2, under 71, above. As some of these contributions may be claimed as business expenses which are deductible, this revenue cost is not included as a tax expenditure.

² For businesses owned by individuals, taxes other than income taxes are considered a cost of doing business and thus deductible in arriving at a net income figure.

³ The breakdown of this total for State and local taxes follows:

Tax:	Revenue Cost (In millions)
Individual income tax.....	\$1,350
General sales taxes.....	775
Gasoline taxes.....	400
Personal property taxes.....	150
Other taxes.....	125
Total	2,800
Property taxes on owner-occupied homes (Reported earlier under housing and community development).....	1,800
Total revenue cost—all State and local nonbusiness taxes.....	4,600

The functional breakdown

The functional breakdown of regular budget outlays (including expenditures and net lending) and "tax expenditures" is presented in table I. In interpreting the amounts in that table, certain aspects should be kept in mind.

Within each functional category the "tax expenditure" total reports the revenue impact of all tax provisions for that function. Each of these tax provisions was discussed in the preceding section, and the revenue cost of each provision was presented separately from any other provision in the tax system, including provisions with a similar function. The revenue costs for each of these provisions taken separately are shown in table II, and the totals taken to table I.

A total of all the provisions is not given here or in the tables. The mathematical total would be an understatement of the true revenue cost of all the provisions taken together because the absence of any single provision would put a taxpayer into a higher rate bracket and thus cause the other provisions to have a larger revenue effect. An effort to take this interaction into account in the estimates of the separate items would require an arbitrary decision as to which provisions were taken into account before other provisions.

Also the special tax provisions undoubtedly have significant effects on the composition and perhaps the level of economic activity. If none of these provisions were in the law, the tax base, the budget, and the economy would be different. We have not attempted to speculate how the Federal budget and the economy might differ from what they now are.

The relative importance of ordinary budget expenditures and of tax expenditures differs sharply by function, as shown in table I. In the budget fields of space research and technology, interest, and general Government, tax expenditures make no direct contribution, although, as with ordinary expenditures, items classified under other budget headings may have an effect in these areas. Tax expenditures constitute a relatively small part of total budget resources used for national defense and for veterans' benefits and services, although the cost of the special tax provisions relative to these functions is \$1.1 billion.

Tax provisions control a large fraction of budget resources employed in several functional categories. With respect to commerce and transportation, a greater volume of budget resources is allocated by current special tax provisions than by direct expenditures. In certain functional categories, such as natural resources, housing and community development, and health, labor, and welfare, tax provisions constitute a major component of total Government activities.

Once again it should be kept in mind that the list of tax provisions is not intended to be exhaustive. In the case of each of the special tax provisions presented above, revenues are effected in connection with a specific form of private or Government economic activity or in connection with a particular form of expenditure. Many reasons for the enactment of these tax provisions may be found other than the promotion of the functional activity under which they are listed, just as a multitude of forces affect the approval of direct Government expenditures which are nonetheless summarized under specific functional headings. This analysis in no way reflects on the wisdom of such reasons. It is clear, however, that more efficient use of resources by the Federal Government is advanced if explicit account is taken of all calls upon budget resources, so that the importance of different budgetary objectives and the effectiveness of alternative uses, whether through direct expenditures, loan subsidies, or tax expenditures, may be fully understood, examined, and reevaluated periodically.

TABLE I.—Estimated budget outlays including tax expenditures, fiscal year 1968
 (Dollar amounts in billions)

Budget functions ¹	Total budget outlays		Tax expenditures	Total	Tax expenditures, as percent of budget expenditures plus net lending
	Expenditures	Net lending			
(1)	(2)	(3)	(4)	(5)	(6)
					Percent
1. National defense.....	\$76.5	(*)	\$0.5	\$77.0	0.7
2. International affairs and finance.....	4.8	\$0.7	.4	5.4	7.3
3. Space research and technology.....	4.8	0	0	4.8	0
4. Agriculture and agricultural resources.....	4.4	.9	.9	6.2	17.5
5. Natural resources.....	2.4	(*)	1.0	4.0	66.0
6. Commerce and transportation.....	7.7	.2	13.3-16.3	21.1-24.1	169.0-207.2
7. Housing and community development.....	.7	3.3	3.9	7.9	99.9
8. Health, labor, and welfare.....	46.4	(*)	15.0	62.0	33.5
9. Education.....	4.2	.4	.7	5.3	15.9
10. Veterans' benefits and services.....	6.6	.4	.6	7.7	7.7
11. Interest.....	13.5	0	0	13.5	0
12. General government and others.....	2.0	(*)	0	2.6	0
13. Aid to State and local government financing.....	n.a.	n.a.	4.0	n.a.	n.a.
Total.....	\$169.9	5.8			

NOTE.—The figures for outlays and net lending are the estimates for fiscal year 1968 in "The Budget of the United States Government: Fiscal Year 1969" (Washington, January 1969), p. 53.

¹ The functions coincide with the budget document except that the heading "Aid to State and Local Government Financing" has been added.

² Includes amounts for contingencies and certain undistributed intragovernmental payments which are included in the budget but not listed separately here.

n.a. Not applicable, since this is not a budget category.

* Amounts differed from zero and fell in the range from -\$40 million (net repayment) to +\$21 million.

TABLE II.—Estimated tax expenditures, fiscal year 1968

(In millions)

Tax expenditures by budget function	Revenue cost
1. National defense:	
Exclusion of benefits and allowances to Armed Forces personnel.....	\$500
2. International affairs and finance:	
a. Individual taxation:	
Exemption for certain income earned abroad by U.S. citizens.....	40
Exclusion of income earned in U.S. possessions.....	10
b. Corporate taxation:	
Western Hemisphere Trade Corporations.....	50
Exclusion of gross-up on dividends of less-developed country corporations.....	50
Exclusion of controlled foreign subsidiaries.....	150
Exclusion of income earned in U.S. possessions.....	70
Total.....	370
3. Agriculture and agricultural resources:	
Farming: expensing and capital gain treatment.....	800
Timber: capital gain treatment for certain income.....	130
Total.....	930
4. Natural resources:	
Expensing of exploration and development costs.....	300
Excess of percentage over cost depletion.....	1,300
Capital gains treatment of royalties on coal and iron ore.....	5
Total.....	1,605

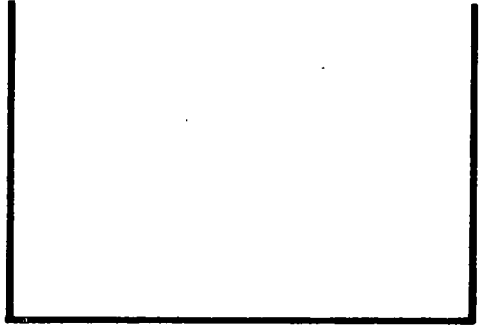
340 1968 REPORT OF THE SECRETARY OF THE TREASURY

TABLE II.—Estimated tax expenditures, fiscal year 1968—Continued

(In millions)

Tax expenditures by budget function	Revenue cost
5. Commerce and transportation:	
a. Investment credit.....	\$2,300
b. Excess depreciation on buildings (other than rental housing).....	500
c. Dividend exclusion.....	225
d. Capital gains: individuals.....	5,500-8,500
e. Capital gains: corporations (other than agriculture and natural resources).....	500
f. Excess bad debt reserves of financial institutions.....	600
g. Exemption of credit unions.....	40
h. Deductibility of interest on consumer credit.....	1,300
i. Expensing of research and development expenditures.....	500
j. \$25,000 surtax exemption.....	1,800
k. Deferral of tax on shipping companies.....	10
Total.....	13,275 16,275
6. Housing and community development:	
Deductibility of interest on mortgages on owner-occupied homes.....	1,900
Deductibility of property taxes on owner-occupied homes.....	1,800
Excess depreciation on rental housing.....	250
Total.....	3,950
7. Health, labor, and welfare:	
a. Provisions relating to aged, blind, and disabled:	
Combined cost for additional exemption, retirement income credit, and exclusion of OASDHI for aged.....	2,300
Additional exemption for blind.....	10
b. "Sick pay" exclusion.....	85
c. Exclusion of unemployment insurance benefits.....	300
d. Exclusion of workmen's compensation benefits.....	150
e. Exclusion of public assistance benefits.....	50
f. Treatment of pension plans:	
Plans for employees.....	3,000
Plans for self-employed persons.....	60
g. Exclusion of other employee benefits:	
Premiums on group term life insurance.....	400
Deductibility of accident and death benefits.....	25
Medical insurance premiums and medical care.....	1,100
Privately financed supplementary unemployment benefits.....	25
Meals and lodging.....	150
h. Exclusion of interest on life insurance savings.....	900
i. Deductibility of charitable contributions (other than education), including untaxed appreciation.....	2,200
j. Deductibility of medical expenses.....	1,500
k. Deductibility of child and dependent care expenses.....	25
l. Deductibility of casualty losses.....	70
m. Standard deduction.....	3,200
Total.....	15,550
8. Education:	
a. Additional personal exemption for students.....	500
b. Deductibility of contributions to educational institutions.....	170
c. Exclusion of scholarships and fellowships.....	50
Total.....	720
9. Veterans' benefits and services:	
Exclusion of certain benefits.....	550
10. Aid to State and local government financing:	
Exemption of interest on State and local debt.....	1,800
Deductibility of nonbusiness State and local taxes (other than on owner-occupied homes).....	2,800
Total.....	4,600

[Excerpt from statement of Secretary of the Treasury Barr before Joint Economic Committee, U.S. Congress, in hearings on the 1969 Economic Report of the President, January 17, 1969, part I, pages 11-44. (See p. 112.)]



Comparison of Budget Outlays and Tax Expenditures by Function



Fiscal Year 1970

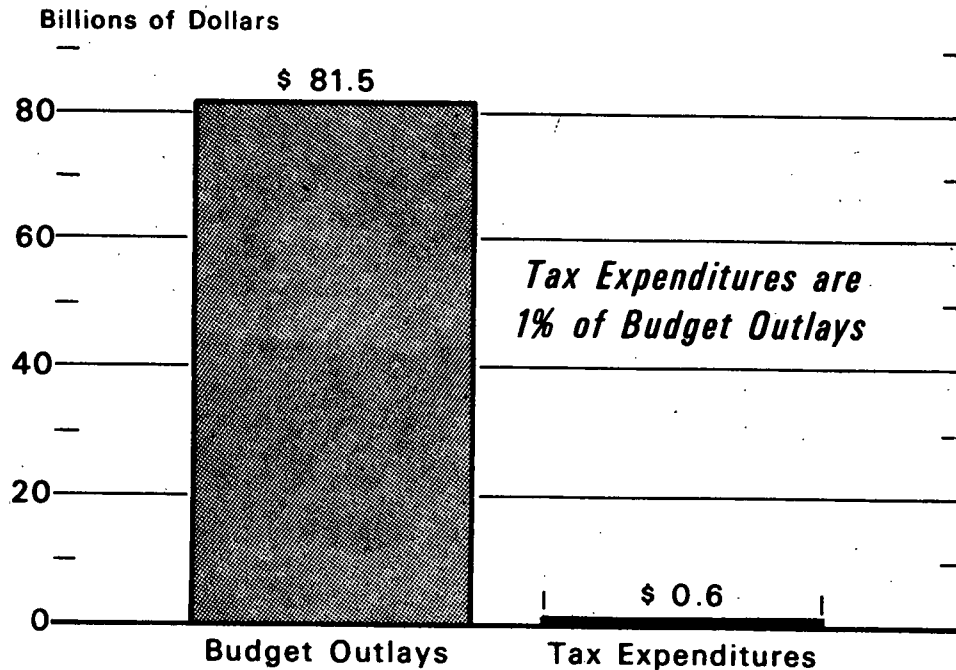


Table 1. National Defense

	<u>Tax expenditures (in millions of dollars) 1968</u>		
Exclusion of military benefits and allowances	500		
	<u>Budget outlays plus tax expenditures (in billions of dollars)</u>		
	<u>1968</u>	<u>1969</u>	<u>1970</u>
Budget outlays:			
Expenditures	80.5	81.0	81.5
Net lending	- *	- *	- *
Total	<u>80.5</u>	<u>81.0</u>	<u>81.5</u>
Tax expenditures	0.5	0.6	0.6
Total budget outlays plus tax expenditures	<u>81.0</u>	<u>81.6</u>	<u>82.1</u>
Tax expenditures as percent of budget outlays	1%	1%	1%

*Less than \$50 million.

National Defense, Fiscal 1970



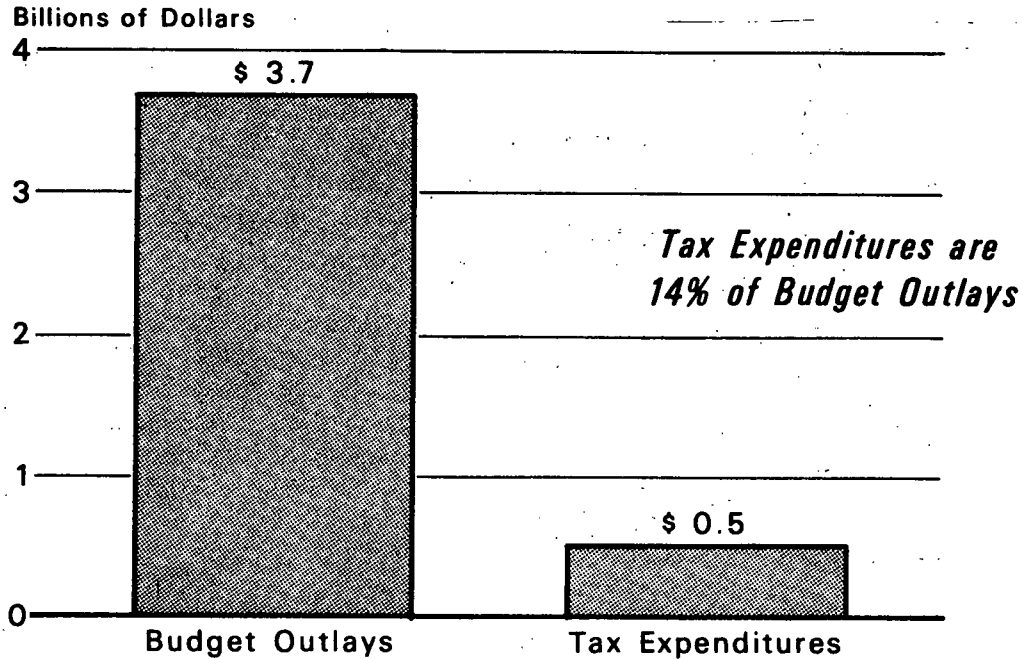
SOURCE: DATA FROM THE BUDGET OF THE U.S. GOVERNMENT, 1970 AND THE DEPARTMENT OF THE TREASURY ESTIMATES.

Chart 1

Table 2. International Affairs and Finance

	<u>Tax expenditures (in millions of dollars)</u>		<u>1968</u>
Individual taxation:			
Exemption for certain income earned abroad by U. S. citizens		40	
Exclusion of income earned in U. S. possessions		10	
Corporate taxation:			
Western Hemisphere trade corporations		50	
Exclusion of gross-up on dividends of less developed country corporations		50	
Exclusion of controlled foreign subsidiaries		150	
Exclusion of income earned in U. S. possessions		<u>70</u>	
Total tax expenditures			370
	<u>Budget outlays plus tax expenditures (in billions of dollars)</u>		
Budget outlays:	<u>1968</u>	<u>1969</u>	<u>1970</u>
Expenditures	3.7	3.6	3.5
Net lending	0.9	0.3	0.2
Total	<u>4.6</u>	<u>3.9</u>	<u>3.7</u>
Tax expenditures	0.4	0.4	0.5
Total budget outlays plus tax expenditures	<u>5.0</u>	<u>4.3</u>	<u>4.2</u>
Tax expenditures as percent of budget outlays	9%	10%	14%

International Affairs and Finance, Fiscal 1970



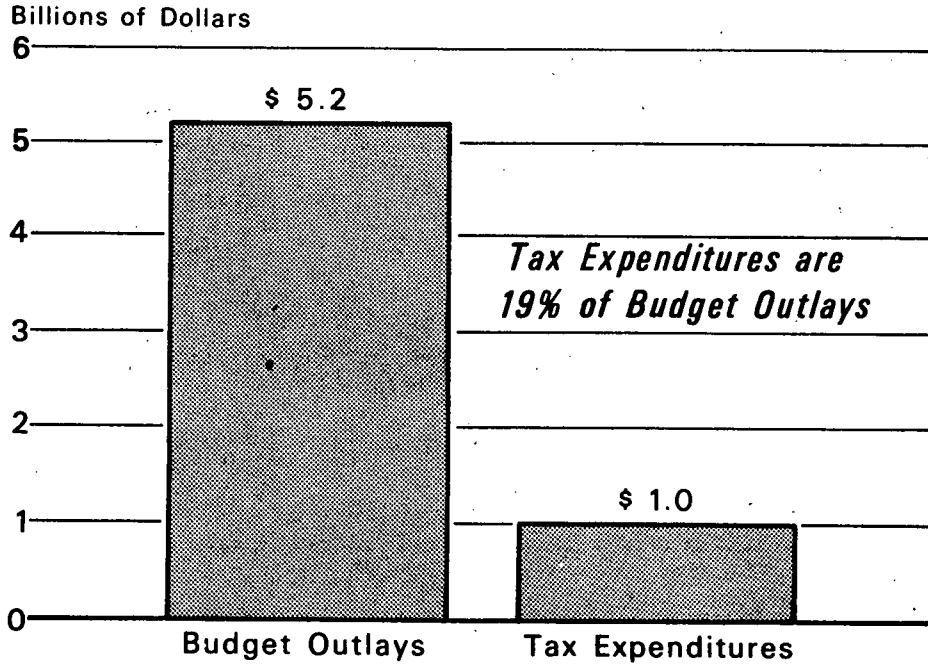
SOURCE: DATA FROM THE BUDGET OF THE U.S. GOVERNMENT, 1970 AND THE DEPARTMENT OF THE TREASURY ESTIMATES.

Chart 2

Table 3. Agriculture and Agricultural Resources

	<u>Tax expenditures (in millions of dollars)</u>		<u>1968</u>
Farming: Expensing and capital gains treatment			800
Timber: Capital gains treatment for certain income			<u>130</u>
Total tax expenditures			930
	<u>Budget outlays plus tax expenditures (in billions of dollars)</u>		
	<u>1968</u>	<u>1969</u>	<u>1970</u>
Budget outlays:			
Expenditures	4.8	5.3	5.1
Net lending	<u>1.1</u>	<u>0.1</u>	<u>0.1</u>
Total	5.9	5.4	5.2
Tax expenditures	<u>0.9</u>	<u>1.0</u>	<u>1.0</u>
Total budget outlays plus tax expenditures	6.8	6.4	6.2
Tax expenditures as percent of budget outlays	15%	19%	19%

Agriculture and Agricultural Resources, Fiscal 1970



SOURCE: DATA FROM THE BUDGET OF THE U.S. GOVERNMENT, 1970 AND THE DEPARTMENT OF THE TREASURY ESTIMATES.

Chart 3

Table 4. Natural Resources

	<u>Tax expenditures (in millions of dollars)</u>	<u>1968</u>
Expensing of exploration and development costs		300 ^{1/}
Excess of percentage over cost depletion		1,300 ^{1/}
Capital gains treatment of royalties on coal and iron ore		<u>5</u>
Total		1,605

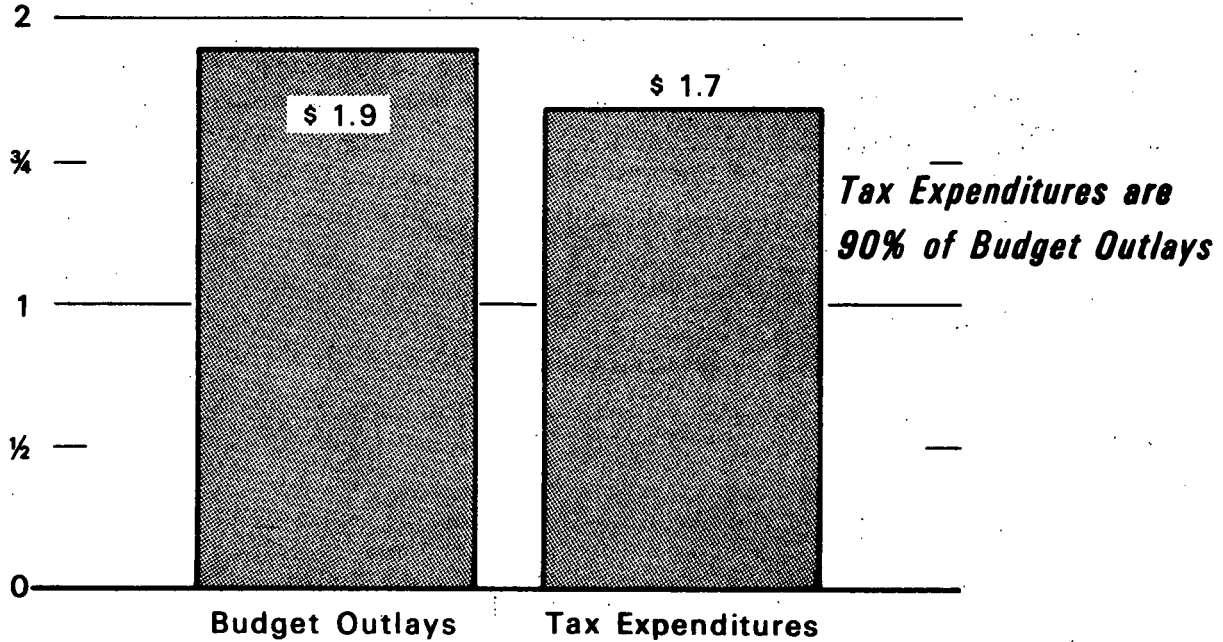
	<u>Budget outlays plus tax expenditures (in billions of dollars)</u>		
	<u>1968</u>	<u>1969</u>	<u>1970</u>
Budget outlays:			
Expenditures	1.7	1.9	1.9
Net lending	*	*	*
Total	<u>1.7</u>	<u>1.9</u>	<u>1.9</u>
Tax expenditures	1.6	1.7	1.7
Total budget outlays plus tax expenditures	<u>3.3</u>	<u>3.6</u>	<u>3.6</u>
Tax expenditures as percent of budget outlays	94%	90%	90%

^{1/} In the absence of the expensing of exploration and development costs and percentage depletion, the first year revenue effect would be \$750 million and \$1.5 billion, respectively. The difference from the estimates shown which are based on long-run effect is due to the fact that taxpayers with mineral properties would initially have little or no tax basis because of deductions in prior years.

*Less than \$50 million.

Natural Resources

Billions of Dollars



SOURCE: DATA FROM THE BUDGET OF THE U.S. GOVERNMENT, 1970 AND THE DEPARTMENT OF THE TREASURY ESTIMATES.

Chart 4

Table 5. Commerce and Transportation

<u>Tax expenditures (in millions of dollars)</u>	<u>1968</u>
Investment credit	2,300
Excess depreciation on buildings	500
Dividend exclusion	225
Capital gains: Corporations (other than Agricultural and Natural Resources)	500
Excess bad debt reserves of financial institutions	600
Exemption of credit unions	40
Deductibility of interest on consumer credit	1,300
Expensing of research and development expenditures	500
\$25,000 surtax exemption	1,800
Deferral of tax on shipping companies	10
Total	<u>7,775</u> ^{1/}

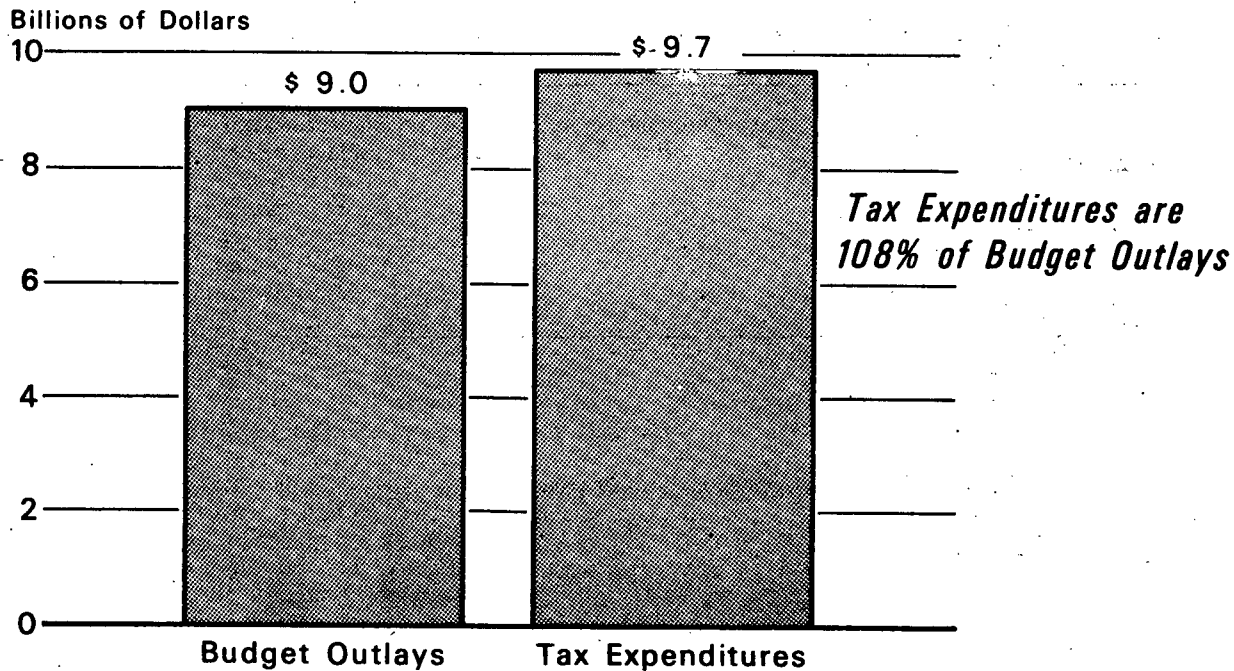
Budget outlays plus tax expenditures (in billions of dollars)

	<u>1968</u>	<u>1969</u>	<u>1970</u>
Budget outlays:			
Expenditures	7.8	8.1	8.9
Net lending	0.2	*	0.1
Total	<u>8.0</u>	<u>8.1</u>	<u>9.0</u>
Tax expenditures	7.8	9.2	9.7
Total budget outlays plus tax expenditures	<u>15.8</u>	<u>17.3</u>	<u>18.7</u>
Tax expenditures as percent of budget outlays	98%	114%	108%

^{1/} The revenue cost for 1968 under this category differs from that in Exhibit 29 of the Secretary's Annual Report due to the exclusion of capital gains - individual and its presentation as a separate item in this revised analysis.

*Less than \$50 million.

Commerce and Transportation



SOURCE: DATA FROM THE BUDGET OF THE U.S. GOVERNMENT, 1970 AND THE DEPARTMENT OF THE TREASURY ESTIMATES.

Chart 5

Table 6. Community Development and Housing

Tax expenditures (in millions of dollars) 1968

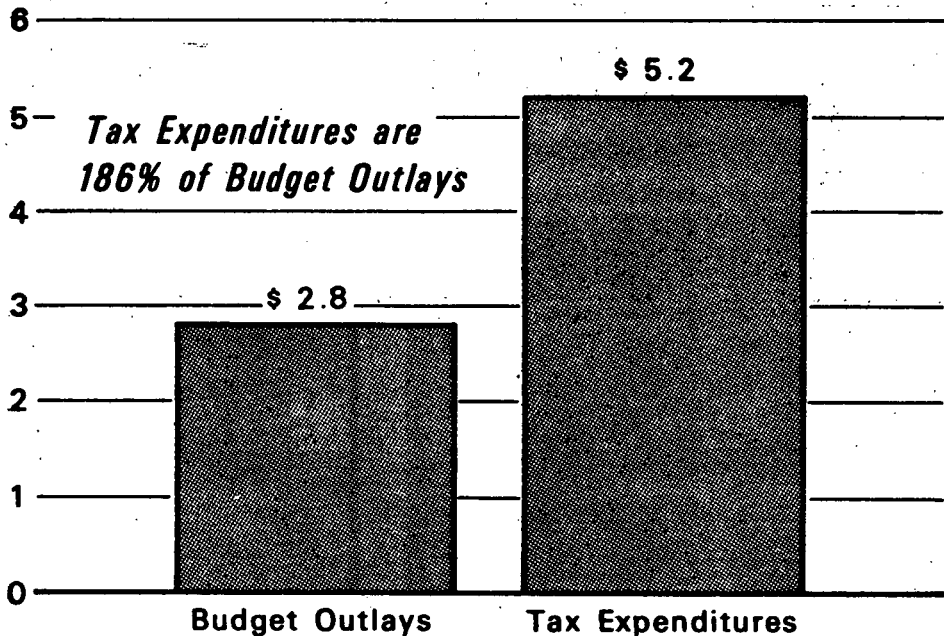
Owner-occupied homes, deductibility of:	
Interest on mortgages	1,900
Property taxes	1,800
Rental housing - excess depreciation	<u>250</u>
Total	3,950

Budget outlays plus tax expenditures (in billions of dollars)

	<u>1968</u>	<u>1969</u>	<u>1970</u>
Budget outlays:			
Expenditures	1.0	1.3	2.6
Net lending	<u>3.1</u>	<u>1.0</u>	<u>0.2</u>
Total	4.1	2.3	2.8
Tax expenditures	<u>4.0</u>	<u>4.7</u>	<u>5.2</u>
Total budget outlays plus tax expenditures	8.1	7.0	8.0
Tax expenditures as percent of budget outlays	98%	204%	186%

Community Development and Housing, Fiscal 1970

Billions of Dollars



SOURCE: DATA FROM THE BUDGET OF THE U.S. GOVERNMENT, 1970 AND THE DEPARTMENT OF THE TREASURY ESTIMATES.

Chart 6

Table 7. Health and Welfare

Tax expenditures (in millions of dollars) 1968

Aged, blind, and disabled:	
Additional exemption, retirement income credit and exclusion of OASDHI for aged	2,300
Additional exemption for blind	10
Exclusion for "sick pay"	85
Exclusion of unemployment insurance benefits	300
Exclusion of workmen's compensation benefits	150
Exclusion of public assistance benefits	50
Exclusion for employee pensions	3,000
Deduction for self-employed retirement	60
Exclusion of other employee benefits:	
Premiums on group term life insurance	400
Accident and death benefits	25
Medical insurance premiums and medical care	1,100
Privately financed supplementary unemployment benefits	25
Meals and lodging	150
Exclusion of interest on life insurance savings	900
Deductibility by individuals of charitable contributions (other than education) including untaxed appreciation	2,200
Deductibility of medical expenses	1,500
Deductibility of child and dependent care expenses	25
Deductibility of casualty losses	70
Standard deduction	<u>3,200</u> 1/
Total	15,550

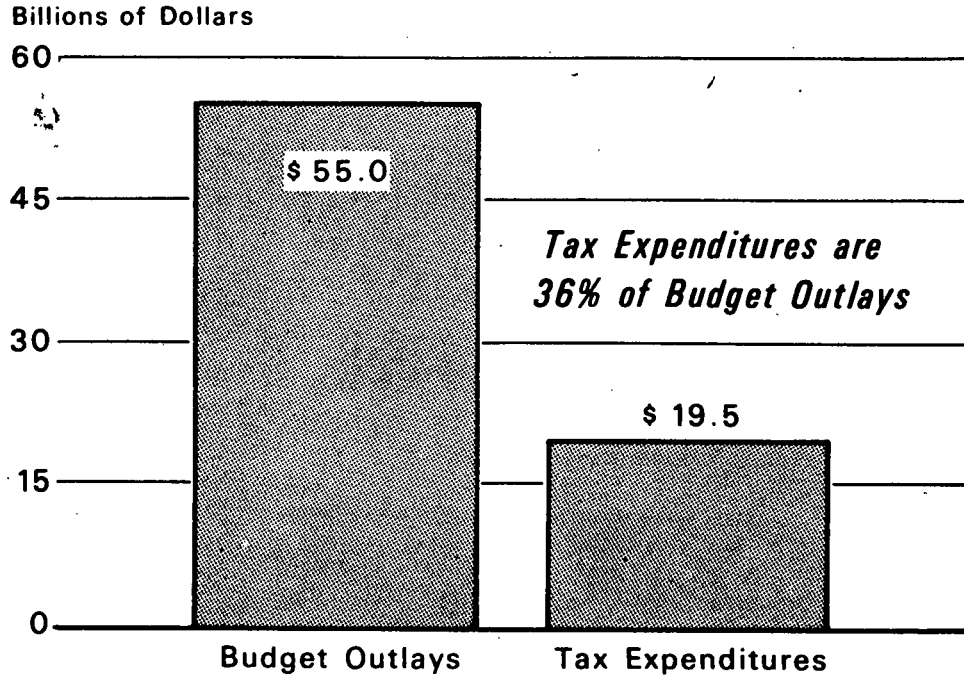
Budget outlays plus tax expenditures (in billions of dollars)

	<u>1968</u>	<u>1969</u>	<u>1970</u>
Budget outlays:			
Expenditures	43.4	49.5	55.0
Net lending	0.1	-0.6	*
Total	<u>43.5</u>	<u>48.9</u>	<u>55.0</u>
Tax expenditures	<u>15.6</u>	<u>18.0</u>	<u>19.5</u>
Total budget outlays plus tax expenditures	<u>59.1</u>	<u>66.9</u>	<u>74.5</u>
Tax expenditures as percent of budget outlays	36%	37%	36%

1/ In the absence of the 10 percent standard deduction and most itemized non-business deductions, the minimum standard deduction as presently structured would be taken by all taxpayers and its revenue cost would be relatively large. Under present treatment, the minimum standard deduction, in keeping with its objectives, is claimed almost entirely by low-income taxpayers and its revenue cost is \$300 million. The revenue estimate assumes the minimum standard deduction is designed to assist only low-income taxpayers. The minimum standard deduction is regarded in this analysis as related to the system of personal exemptions and thus a part of the structure of an income tax system based on ability to pay, rather than as a tax expenditure.

*Less than \$50 million.

Health and Welfare, Fiscal 1970



SOURCE: DATA FROM THE BUDGET OF THE U.S. GOVERNMENT, 1970 AND THE DEPARTMENT OF THE TREASURY ESTIMATES.

Chart 7

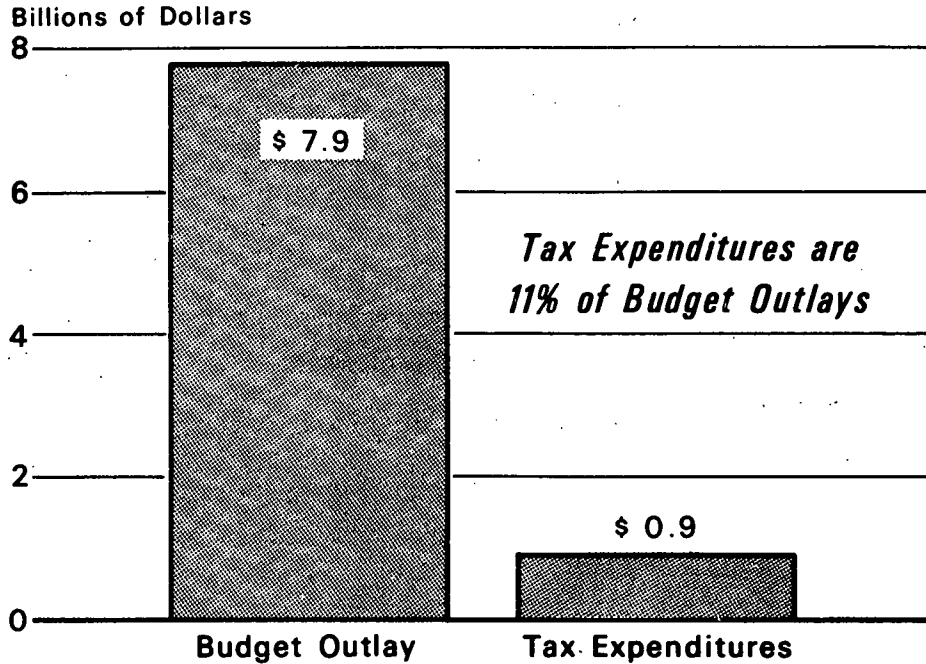
Table 8. Education and Manpower

	<u>Budget outlays plus tax expenditures (in billions of dollars)</u>		
	<u>1968</u>	<u>1969</u>	<u>1970</u>
Budget outlays:			
Expenditures	6.6	6.9	7.6
Net lending	0.4	0.3	0.3
Total	<u>7.0</u>	<u>7.2</u>	<u>7.9</u>
Tax expenditures	0.7	0.8	0.9
Total budget outlays plus tax expenditures	<u>7.7</u>	<u>8.0</u>	<u>8.8</u>
Tax expenditures as percent of budget outlays	10%	11%	11%

Tax expenditures (in millions of dollars) 1968

Additional personal exemption for students	500
Deductibility of contributions by individuals to educational institutions	170
Exclusion of scholarships and fellowships	<u>50</u>
Total	<u>720</u>

Education and Manpower



SOURCE: DATA FROM THE BUDGET OF THE U.S. GOVERNMENT, 1970 AND THE DEPARTMENT OF THE TREASURY ESTIMATES.

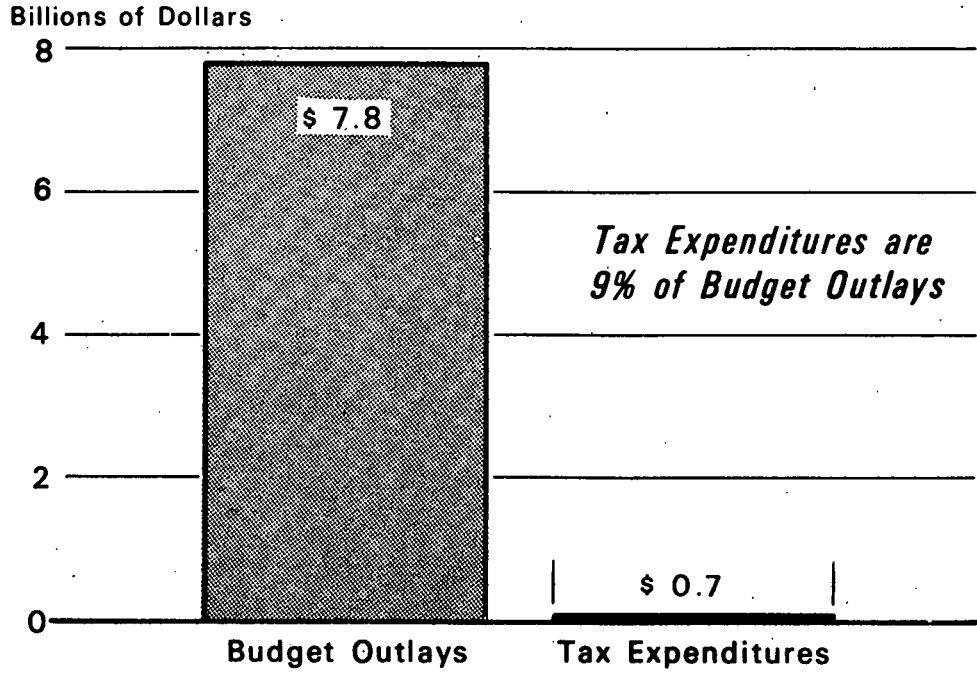
Chart 8

Table 9. Veterans Benefits and Services

	<u>Tax expenditures (in millions of dollars)</u>		<u>1968</u>
Exclusion of certain benefits			550
	<u>Budget outlays plus tax expenditures (in billions of dollars)</u>		
	<u>1968</u>	<u>1969</u>	<u>1970</u>
Budget outlays:			
Expenditures	6.7	7.4	7.8
Net lending	0.1	0.3	*
Total	<u>6.8</u>	<u>7.7</u>	<u>7.8</u>
Tax expenditures	0.6	0.6	0.7
Total budget outlays plus tax expenditures	<u>7.4</u>	<u>8.3</u>	<u>8.5</u>
Tax expenditures as percent of budget outlays	9%	8%	9%

*Less than \$50 million.

Veterans Benefits and Services



SOURCE: DATA FROM THE BUDGET OF THE U.S. GOVERNMENT, 1970 AND THE DEPARTMENT OF THE TREASURY ESTIMATES.

Chart 9

Table 10. Aid to State and Local Government Financing

<u>Tax expenditures (in millions of dollars)</u>	<u>1968</u>
Exemption of interest on State and local debt obligations	1,800
Deductibility of nonbusiness State and local taxes (other than on owner-occupied homes): <u>1/</u>	
Individual income tax	1,350
General sales taxes	775
Gasoline taxes	400
Personal property taxes	150
Other taxes	<u>125</u>
Total	2,800
Property taxes on owner-occupied homes (included under Community Development and Housing)	<u>1,800</u>
Total - All State and local nonbusiness taxes	<u>4,600</u>

1/ For businesses owned by individuals, taxes other than income taxes are considered a cost of doing business and thus deductible in arriving at a net income figure.

AID TO STATE AND LOCAL GOVERNMENT FINANCING

The Federal Government aids State and local government financing through certain tax provisions. These take two forms: (1) the itemized deductions for nonbusiness State and local taxes; (2) the exemption from Federal income tax of interest on State and local government obligations. The revenue costs to the Federal Government of these special tax provisions are shown in Table 10. There is no single functional category in the present Federal budget for aid to State and local government financing, and thus there is no chart for this item.

CAPITAL GAINS - INDIVIDUAL INCOME TAX

The tax expenditures involved in the present treatment of capital gains of individuals are placed in the range of \$5.5 to \$8.5 billion. This revenue cost includes the exclusion from income tax of appreciation on assets transferred at death, the exclusion of half the gains from the sale of capital assets held more than six months, and the maximum rate of 25 percent. No table or chart is shown for this heading, because these tax expenditures would fall under a variety of functions in the Federal budget, including commerce and transportation, agriculture and agricultural resources, community development and housing, and health and welfare. Available data, however, do not provide a basis for accurate distribution among these functions. Thus, to avoid having to choose any single predominant category but to identify the importance of this special provision, a new heading outside any budget classification is included for this item.

Separation of this item from the budget classifications leads to an understatement of the amounts of tax expenditures for the functional categories affected.

SUPPLEMENTARY STATEMENT OF JOSEPH W. BARR

TAX EXPENDITURES: GOVERNMENT EXPENDITURES MADE THROUGH THE INCOME TAX SYSTEM

The Annual Report of the Secretary of the Treasury for fiscal year 1968 includes an exhibit which presents Government expenditures for 1968 made through the income tax system (Exhibit 29). The availability of the budget for fiscal year 1970 enables us to present an updating of tax expenditures to cover the fiscal years 1968, 1969, and 1970 on a basis consistent with the 1970 budget data and classifications. The following statement is a condensed and revised version of the exhibit in the Secretary's 1968 Annual Report with the updated figures.

PURPOSE OF ANALYSIS

This analysis extends the budget to include Government expenditures made through the income tax system. The present Federal income tax structure contains a large number of special deductions, credits, exclusions, exemptions, and preferential rates designed to achieve various social and economic objectives. Most of these special provisions serve ends similar in nature to those served by direct Government expenditures or loan programs, and they affect the private economy in the same way. In a specific functional area the Government may have direct expenditures, direct Federal loans, Federal insurance or guarantees of private loans, and interest subsidies which represent alternative methods of accomplishing the purpose which the special tax provision seeks to achieve or encourage. This analysis, together with the fuller presentation in the Secretary's Annual Report, will permit a better understanding of the amount and allocation of resources on both the outlay and revenue side of the 1970 budget.

A tax expenditure has the same impact on the budget surplus or deficit as a direct increase in expenditures. The tax revenues which the Government does not collect because of these special tax provisions, however, are not reported in the budget as presently constituted. The absence of line items—either on the receipts or outlays side of the budget—for these revenue losses thus results in an understatement of the role of Federal Government financial influence on the behavior of individuals and businesses and on income distribution. In many areas the magnitude of tax expenditures approaches and, in some instances, approximates direct outlays having the same objective.

Tax expenditures are not disclosed in the budget and therefore are not subject to careful annual scrutiny in the budget and appropriation process. Budget outlay decisions, on the other hand, involve the departments and agencies, the Bureau of the Budget, the House and Senate program committees which are competent and experienced in their specialized fields, and the appropriation committees. Tax expenditures are not generally considered by the program departments and congressional committees concerned, and are not reviewed annually or periodically to measure the benefits they achieve against the amounts expended.

The purpose of this analysis is to present information which compares tax expenditures with direct expenditures or loan programs in various functional areas and thus to clarify and present more fully the role of the Federal Government in these areas. Such a comparison should be helpful in the allocation of public resources.

A few illustrations will indicate how tax expenditures are alternatives to direct expenditures or Government lending programs. Under the functional category of health and welfare, the budget lists large direct expenditures which benefit the aged. In addition, \$2.3 billion was expended in 1968 through the tax system to aid the elderly.

Direct expenditures for natural resources are itemized in the budget. To these should be added the \$1.6 billion assistance the tax system provides these industries by permitting the expensing of certain capital costs, the use of percentage depletion in excess of cost depletion, and special capital gains treatment for iron ore and coal royalties.

In the field of housing the Government now provides direct subsidies to lower the interest rates on mortgages paid by buyers of certain homes. Homeownership is also subsidized through the tax deductions for interest paid on home mortgages and for property taxes on homes which now cost the Government annually about \$1.9 billion and \$1.8 billion, respectively.

SCOPE OF TAX EXPENDITURES

Some of the special tax provisions cause revenue to be lost to the Government forever because the current tax base or the tax rates are reduced without any offsetting increase later. Such tax expenditures correspond closely to direct expenditures.

Other special tax provisions serve to defer the time when the taxes will be paid. For a particular taxpayer, transaction, or asset, the special provision may really represent a deferral of tax. However, for stable or growing businesses with an indefinite life, for the Government, and for the entire economy, the deferral of taxes continues forever under most of these provisions; furthermore, in an expanding economy the aggregate amount of deferred taxes tends to grow year after year. Examples of special tax provisions which cause deferral of taxes include: Deduction of employer and self-employed contributions to private pension plans and exemption of investment income of such plans; accelerated depreciation deductions on buildings; net income reinvested in ship construction and renovation by certain shipping companies; expensing of capital costs in agriculture and natural resource industries; and exclusion of nonrepatriated earnings of foreign subsidiaries.

Special tax provisions, which serve to defer but not forgive tax payments, might be compared to net lending in budget terminology. These special tax provisions are generally open-ended, with the extent and duration of their use largely at the taxpayers' option. For these reasons, the tax expenditure classifications in this analysis do not separate the special provisions which reduce taxes from those which defer taxes.

This analysis does not attempt a complete listing of all the special tax provisions. Various items have been excluded for one or more of several reasons:

(a) Some items were excluded because there is insufficient information available on which to base a sound estimate. For example, in the case of depreciation on machinery and equipment, accelerated tax methods may provide an allowance beyond that appropriate to the measurement of net income but it is difficult to measure that difference because the true economic deterioration or obsolescence factor cannot be readily determined.

(b) Some items were excluded where the case for their inclusion in the income base stands on relatively technical or theoretical tax arguments. The imputed rent on owner-occupied homes, for example, involves not only a conceptual problem but difficult practical problems of measurement.

(c) Some items were omitted because of their relatively small quantitative importance.

Other features of our income tax system are considered not as variations from the generally accepted measure of net income or as tax preferences but as a part of the structure of an income tax system based on ability to pay. Such features include personal exemptions and the rate schedules under the individual income tax.

It must be recognized that the exclusions from the listing are to some extent arbitrary. The objective of this analysis is to provide a list of items that would be generally recognized as an intended use of the tax system to achieve results which are now, or could be, achieved through direct Government expenditures. The design of this list seems best served by constructing a minimum list rather than including highly complicated or controversial items that would becloud the utility of this analysis.

TAX EXPENDITURES BY FUNCTIONAL CATEGORY

The tax expenditures resulting from the various special tax provisions are classified under the functional categories used in the budget. In most cases, particular special tax provisions which affect more than one budget category have been classified in the one where the effect is most important. In a few cases where the amount is large and the allocation relatively clear, the tax expenditures are divided between two functions.

No significant tax expenditures are made in three budget categories, space, interest, and general government and others. Two classes of tax expenditures (aid to State and local governments and capital gains—individual) which involve large amounts have not been assigned to specific functional categories for the reasons given in those sections of the analysis.

All estimates of tax expenditures resulting from special tax provisions represent revenues lost on an annual basis. The estimates of revenue foregone are, in general, based on the assumption that such provisions never existed, or, alternatively, that such provisions have been withdrawn sufficiently long ago that we are now beyond the period needed to permit an equitable transition to a new tax situation.

The revenue cost estimated for these special provisions is not in many cases the revenue change which would result in the first full year if these provisions were withdrawn. Replacement of some or all of these provisions by direct expenditures or lending programs might change the level and composition of economic activity. The revenue cost of each special tax provision presented for 1968 would, of course, generally vary over time with growth in the economy and changes in various parts of the tax base. Also, a realistic approach to any change in these provisions would provide in many situations transition arrangements which would effect the revenue change gradually over a period of years.

Another key assumption is that economic activity for the year would not have been affected by the absence of these special provisions. This, of course, is a simplifying assumption for tax expenditures undoubtedly have significant effects on the composition and perhaps the level of economic activity. Also, in the absence of these tax benefits, there would doubtless have been changes in Government direct spending and net lending to accomplish some of the objectives of the existing provisions. No attempt has been made to speculate how the budget and the economy might differ if none of these provisions were in the law.

No account is taken here of other taxes, such as payroll taxes, estate and gift taxes, excises, or tariffs. The assumption inherent in current law, that corporations are separate entities and subject to income taxation independently from their shareholders, is adhered to in this analysis.

The tax expenditures shown here for the three fiscal years 1968, 1969, and 1970 are figured at the tax rate which affect the revenues in these years.

A brief description of each of the special tax provisions for which a tax expenditure estimate is shown accompanies the estimates.

National Defense

The supplements to salaries of military personnel by provision of quarters and meals on military bases and off-base quarters allowances for military families, and virtually all salary payments and reenlistment bonuses to military personnel serving in combat zones are excluded from tax.

TABLE 1.—NATIONAL DEFENSE

Tax expenditures, 1968

[In millions of dollars]

Exclusion of military benefits and allowances..... 500

Budget Outlays Plus Tax Expenditures

[In billions of dollars]

	1968	1969	1970
Budget outlays:			
Expenditures.....	80.5	81.0	81.5
Net lending.....	(.1)	(.1)	(.1)
Total.....	80.5	81.0	81.5
Tax expenditures.....	.5	.6	.6
Total budget outlays plus tax expenditures.....	81.0	81.6	82.1
Tax expenditures as percent of budget outlays.....	1	1	1

¹ Less than \$50,000,000.

International Affairs and Finance

Individual taxation.—For citizens of the United States, income earned abroad up to \$20,000 for each complete tax year is exempted from taxation if the taxpayer is a bona fide resident of a foreign country for an uninterrupted period that includes 1 full tax year or, if he is present there 510 days during a period of 18 consecutive months. After 3 years, foreign resident taxpayers can exclude up to \$25,000 a tax year.

United States citizens receiving from sources in a U. S. possession may, under certain conditions, exclude such income from tax.

Corporate taxation.—Domestic corporations which qualify as Western Hemisphere Trade Corporations are entitled to a special deduction which reduces their tax rate by 14 percentage points.

Income of foreign branches and subsidiaries of U. S. corporations is subject to taxation abroad and in the United States. A credit is allowed against U. S. income tax for the foreign income taxes paid, up to the amount of U. S. tax liability. U. S. corporations deriving income from foreign subsidiaries may claim a credit for foreign corporate profits tax deemed paid on that income, as well as for foreign taxes imposed directly on that income. If the subsidiary is in a developed country, the parent corporation must include both creditable foreign taxes in its U. S. taxable income; if the subsidiary is in a less developed country, the corporation need not "gross-up" its income to include the creditable portion of foreign profits tax.

United States corporations are not required currently to file consolidated returns which include the unrepatriated earnings of controlled foreign subsidiaries.

Domestic corporations deriving the bulk of their income in U. S. possessions may, under certain conditions, exclude such income from tax.

TABLE 2.—INTERNATIONAL AFFAIRS AND FINANCE

Tax expenditures, 1968			
[In millions of dollars]			
Individual taxation:			
Exemption for certain income earned abroad by U.S. citizens.....			40
Exclusion of income earned in U.S. possessions.....			10
Corporate taxation:			
Western Hemisphere trade corporations.....			50
Exclusion of gross-up on dividends of less developed country corporations.....			50
Exclusion of controlled foreign subsidiaries.....			150
Exclusion of income earned in U.S. possessions.....			70
Total tax expenditures.....			370
Budget outlays plus tax expenditures			
[In billions of dollars]			
	1968	1969	1970
Budget outlays:			
Expenditures.....	3.7	3.6	3.5
Net lending.....	.9	.3	.2
Total.....	4.6	3.9	3.9
Tax expenditures.....	.4	.4	.5
Total budget outlays plus tax expenditures.....	5.0	4.3	4.2
Tax expenditures as percent of budget outlays.....	9	10	14

Agriculture and Agricultural Resources

Farmers, including corporations, may deduct certain costs as current expenses even though these costs represent inventories on hand at the end of the year or capital improvements.

Capital gains treatment also extends to the sale of livestock, orchards, vineyards, and comparable agricultural activities.

The gain on the cutting of timber is taxed at the rates applicable to long-term capital gains, rather than at ordinary income rate.

TABLE 3.—AGRICULTURE AND AGRICULTURAL RESOURCES

Tax expenditures, 1968	
[In millions of dollars]	
Farming: Expensing and capital gains treatment.....	800
Timber: Capital gains treatment for certain income.....	130
Total tax expenditures.....	930

Budget outlays plus tax expenditures

[In billions of dollars]

	1968	1969	1970
Budget outlays:			
Expenditures.....	4.8	5.3	5.1
Net lending.....	1.1	.1	.1
Total.....	5.9	5.4	5.2
Tax expenditures.....	.9	1.0	1.0
Total budget outlays plus tax expenditures.....	6.8	6.4	6.2
Tax expenditures as percent of budget outlays.....	15	19	19

Natural Resources

Certain capital costs necessary to bring a mineral deposit into production may be deducted as current expenses rather than spread over the useful life of the property. Included in this category are the intangible drilling costs of oil and gas wells and the cost of developing other mineral deposits, such as mine shafts, tunnels, and stripping.

Extractive industries may choose between two methods of recovering capital costs invested in the development of natural resources. Under one method, actual outlays to the extent not immediately expensible may be deducted as "cost depletion" over the productive life of the property, much as other businesses may take deductions for the depreciation of capital goods. Alternatively, businesses in the extractive industries may deduct a prescribed percentage of gross income (at rates ranging from 27.5 percent for oil and gas to 5 percent for certain minerals, but not more than 50 percent of net income) where such "percentage depletion" exceeds "cost depletion." Percentage depletion is not limited to the cost of the investment as is cost depletion. The basis for "cost depletion" is reduced to the extent certain costs are recovered through expensing of exploration and discovery costs and intangible drilling costs. There is no comparable reduction in "percentage depletion" to allow for costs which are allowed as expenses.

Royalties from coal or iron ore deposits are treated as capital gains.

TABLE 4.—NATURAL RESOURCES

Tax Expenditures, 1968

[In millions of dollars]

Expensing of exploration and development costs.....	1,300
Excess of percentage over cost depletion.....	1,300
Capital gains treatment of royalties on coal and iron ore.....	5
Total.....	1,605

Budget Outlays Plus Tax Expenditures

[In billions of dollars]

	1968	1969	1970
Budget outlays:			
Expenditures.....	1.7	1.9	1.9
Net lending.....	(?)	(?)	(?)
Total.....	1.7	1.9	1.9
Tax expenditures.....	1.6	1.7	1.7
Total budget outlays plus tax expenditures.....	3.3	3.6	3.6
Tax expenditures as percent of budget outlays.....	94	90	90

¹ In the absence of the expensing of exploration and development costs and percentage depletion, the 1st year revenue effect would be \$750,000,000 and \$1,500,000,000 respectively. The difference from the estimates shown which are based on longrun effect is due to the fact that taxpayers with mineral properties would initially have little or no tax basis because of deductions in prior years.

² Less than \$50,000,000.

Commerce and Transportation

Investment credit.—Most businesses may take a tax credit equal to 7 percent of the cost of investments in new machinery and equipment made during the year. This credit does not lower the basis of the property for calculating the deduction for depreciation.

Excess depreciation on buildings.—To the extent that allowable depreciation for tax purposes exceeds the rate at which assets actually depreciate, business tax liabilities are deferred. Businesses may employ a variety of depreciation schedules for tax purposes, some of which cause a much larger part of asset values to be written off in early years of the asset's useful life than do others. The revenue cost of allowing for buildings depreciation methods for tax purposes that reduce asset value more rapidly than straight-line depreciation (the method typically used in financial statements) is shown below. The part based on rental housing is listed under community development and housing. The tax depreciation allowed for machinery and equipment is closer to actual depreciation than that allowed on buildings. In addition, the code permits full recapture as ordinary income of profits resulting from excess depreciation on machinery and equipment, but recapture of only a declining and then disappearing proportion of such profits on buildings. In view of this and the difficulty of estimating the divergence, if any, between depreciation allowed for tax purposes and actual depreciation, depreciation for machinery and equipment is not included here as a tax expenditure.

Dividend exclusion.—Individual income taxpayers may exclude \$100 of dividends from income subject to tax.

Capital gains—Corporation income tax.—Capital gains of corporations are subject to a tax of 25 percent while the rate applicable to other corporate income above \$25,000 is 48 percent (excluding the temporary surcharge).

Bad debt reserves of banks and other financial institutions.—Commercial banks, mutual savings banks, building and loan associations, and cooperative banks are permitted to set aside bad debt reserves based on stipulated fractions of deposits, of loans outstanding, or of taxable income before computation for bad debts. The amounts set aside typically greatly exceed actual loss experience and reasonable expectations as to future losses.

Credit unions.—Credit unions are exempt from Federal income tax.

Deduction of interest on consumer credit.—Interest paid on consumer credit is allowed as an itemized nonbusiness deduction for individuals.

Expensing of research and development expenditures.—Expenditures by businesses for research and development (R&D) are carried out to find new products or processes, to reduce costs, or for other purposes. In nearly all cases, benefits from such expenditures will accrue for well over 1 year. For tax purposes business may deduct all R&D expenditures in the year during which they are incurred, or they may amortize them over not less than 5 years.

Surtax exemption (\$25,000).—Corporations pay income tax at the rate of 22 percent on all taxable income plus a surtax of 26 percent on taxable income in excess of \$25,000 (excluding the temporary surcharge). Each corporation therefore enjoys a surtax exemption of \$25,000. This exemption is intended to encourage small or new businesses.

Deferral of tax on shipping companies.—Certain companies which operate U.S. flag vessel on foreign trade routes receive an indefinite deferral of income taxes on that portion of their net income which is used for shipping purposes, primarily construction, modernization, and major repairs of ships.

TABLE 5.—COMMERCE AND TRANSPORTATION

Tax Expenditures, 1968	
(In millions of dollars)	
Investment credit.....	2,300
Excess depreciation on buildings.....	500
Dividend exclusion.....	225
Capital gains: Corporations (other than agricultural and natural resources).....	500
Excess bad debt reserves of financial institutions.....	600
Exemption of credit unions.....	40
Deductibility of interest on consumer credit.....	1,300 ¹
Expensing of research and development expenditures.....	500
\$25,000 surtax exemption.....	1,800
Deferral of tax on shipping companies.....	10
Total.....	17,775

Budget Outlays Plus Tax Expenditures
(In billions of dollars)

	1968	1969	1970
Budget outlays:			
Expenditures.....	7.8	8.1	8.9
Net lending.....	.2	(?)	.1
Total.....	8.0	8.1	9.0
Tax expenditures.....	7.8	9.2	9.7
Total budget outlays plus tax expenditures.....	15.8	17.3	18.7
Tax expenditures as percent of budget outlays.....	98	114	108

¹ The revenue cost for 1968 under this category differs from that in exhibit 29 of the Secretary's annual report due to the exclusion of capital gains—individual and its presentation as a separate item in this revised analysis.

² Less than \$50,000,000.

Community Development and Housing

Owner-occupants of homes may deduct mortgage interest and property taxes (but not maintenance outlays or depreciation) as itemized nonbusiness deductions. The owners of rental housing may claim in early years depreciation in excess of straight-line depreciation. (See Table 5.)

TABLE 6.—COMMUNITY DEVELOPMENT AND HOUSING

Tax Expenditures, 1968	
(In millions of dollars)	
Owner-occupied homes, deductibility of:	
Interest on mortgages.....	1,900
Property taxes.....	1,800
Rental housing, excess depreciation.....	250
Total.....	3,950

Budget Outlays Plus Tax Expenditures
(In billions of dollars)

	1968	1969	1970
Budget outlays:			
Expenditures.....	1.0	1.3	2.6
Net lending.....	3.1	1.0	.2
Total.....	4.1	2.3	2.8
Tax expenditures.....	4.0	4.7	5.2
Total budget outlays plus tax expenditures.....	8.1	7.0	8.0
Tax expenditures as percent of budget outlays.....	98	204	186

Health and Welfare

A large variety of direct expenditures and transfer payments contribute to health and welfare of families and individuals, both currently and in later years. A considerable number of special tax provisions serve related ends.

Provisions relating to the aged, blind, and disabled.—Individual taxpayers age 65 and over may claim two personal exemptions of \$600 and a second \$100 minimum standard deduction (while persons under age 65 may claim only one of each). The revenue cost of these additional items is \$500 million.

Aged recipients of old age, survivors, and health benefits under the OASDHI program and of railroad retirement benefits are not required to include such benefits in computing tax liability. This revenue cost is \$525 million.¹

Individuals over age 65 may claim a tax credit of up to \$228.60 (15 percent of \$1,524) for a single person or \$342.90 (15 percent of \$2,286) for a married couple based on retirement income from all sources except social security, railroad retirement, or other tax-exempt benefits. In effect, the provision permits taxpayers with taxable retirement income a tax benefit approximately comparable to that accorded recipients of social security and similar tax-exempt benefit payments. The revenue cost is \$200 million.

The combined revenue cost of these three provisions is \$2.3 billion. Because of the effect of the interrelationship of the three provisions on the tax base, the combined cost exceeds the sum of the three provisions taken separately, since the absence of one provision would increase the residual significance of the others.

The blind qualify for two \$600 personal exemptions and an extra \$100 minimum standard deduction.

"Sick pay" exclusions.—Certain payments financed by an employer in lieu of wages during periods of employee injury or sickness are excluded from the employee's income.

Exclusion of unemployment insurance benefits.—Benefits paid by State unemployment insurance plans are financed by a tax on wages paid by the employer and deductible by him, but these benefits are excluded from the employee's income.

Exclusion of workmen's compensation benefits.—Benefits paid under workmen's compensation are excluded from employee's income. These payments are primarily intended to replace earnings lost due to a work-related injury or illness, although some small part of the total payments is compensation for physical loss, such as an eye or an arm. As in the case of unemployment insurance, the benefits are financed by the employer's contributions and are deductible by him.

Exclusion of public assistance.—Public assistance payments are excluded from taxable income.

Exclusion for employee pensions.—Employer contributions to qualified employee pension and annuity plans are deductible by the employer. Income earned by these plans on their investments is not taxable. When an employee retires and is paid a pension or annuity, only part of the amount received is taxable to the employee. He does not pay taxes on the percentage of the benefit purchased by his contributions excluding from the percentage income earned on his contributions.

The revenue cost of the exclusion of investment income earned by all private pension funds, based on the corporate tax rate is \$1.9 billion. The revenue cost of deduction of the total amount contributed by employers to these qualified plans, based on the corporate tax rate, is \$3.4 billion.

The revenue cost, based on the individual income tax rates applicable to employees, is \$0.7 billion as respects the investment income and \$1.4 billion as respects the employers' contributions.

The greater the extent to which the benefits are vested, the more relevant is the use of the individual tax rate in estimating the revenue cost. Taking this vesting into account, the revenue cost of the treatment of pension plans can be put at \$3 billion.

¹ This revenue estimate is based on treatment comparable to other pensions and regards one quarter of the benefits as approximately the cost of employee contribution.

Deduction for self-employed retirement.—Self-employed individuals are permitted a deduction from taxable income for funds they set aside currently in qualified retirement plans.

Exclusion of other employee benefits.—In addition to the benefits already enumerated, a number of other employee benefits (shown in Table 7), the cost of which is paid at least in part by the employer, are also excluded from income subject to tax. The cost to the employer is deductible, and the benefit to the employee not taxable, in all of these cases.

Exclusion of interest on life insurance savings.—Life insurance policies other than term policies, generally have a savings element in them. Savings in the form of policyholders' reserves are accumulated from the premium payment, and interest is earned on these policyholders' reserves. Such interest income is neither taxable as it accrues nor as an element of death benefits.

Deductibility of contributions for other than education.—Contributions to charitable, religious, or certain other nonprofit organizations are allowed as an itemized deduction for individuals generally up to 30 percent of adjusted gross income. Unlimited contributions, however, may be deducted by those taxpayers (a relatively small number) whose contributions plus income taxes equal 90 percent of taxable income in 8 out of the preceding 10 years.

Taxpayers whose contributions to charitable or educational organizations are in the form of capital assets, usually securities, which have appreciated in value above their cost, obtain a deduction for the contribution at the appreciated value of the asset without taxation on the appreciation in value.

Deductibility of medical expenses.—Medical expenses in excess of 3 percent of adjusted gross income and expenditures for prescribed drugs and medicines in excess of 1 percent of adjusted gross income may be deducted by individuals as itemized nonbusiness deductions. Individuals may also deduct half of the premiums paid for medical care insurance up to a maximum deduction of \$150 per year, without regard to the 3 percent limitation.

Deductibility of child and dependent care expenses.—Deductions for a limited amount of expenditures for the care of children under 13 or incapacitated dependents to enable the taxpayer to work are permitted under certain circumstances.

Deductibility of casualty losses.—Taxpayers may deduct as an itemized nonbusiness deduction the amount in excess of \$100 for each loss due to fire, theft, or other casualty to the extent not compensated by insurance.

Standard deduction.—Individuals may itemize deductions for certain personal nonbusiness expenditures, including charitable contributions, interest payments, and medical and drug expenses above a stated percent of income, and certain other items referred to earlier. The taxpayer is also given the option of deducting—instead of this itemization—standard deduction of 10 percent of adjusted gross income or \$1,000 (\$500 if married and filing separately), whichever is less.

TABLE 7.—HEALTH AND WELFARE

Tax Expenditures, 1968

[In millions of dollars]

Aged, blind, and disabled:	
Additional exemption, retirement income credit and exclusion of OASDHI for aged	2,309
Additional exemption for blind	10
Exclusion for sick pay	85
Exclusion of unemployment insurance benefits	300
Exclusion of unemployment insurance benefits	300
Exclusion of workmen's compensation benefits	150
Exclusion of public assistance benefits	50
Exclusion for employee pensions	3,000
Deduction for self-employed retirement	60
Exclusion of other employee benefits:	
Premiums on group term life insurance	400
Accident and death benefits	25
Medical insurance premiums and medical care	1,100
Privately financed supplementary unemployment benefits	25
Meals and lodging	150
Exclusion of interest on life insurance savings	900
Deductibility by individuals of charitable contributions (other than education) including untaxed appreciation	2,200
Deductibility of medical expenses	1,500
Deductibility of child and dependent care expenses	25
Deductibility of casualty losses	70
Standard deduction	13,200
Total	15,550

Budget Outlays Plus Tax Expenditures

[In billions of dollars]

	1968	1969	1970
Budget outlays:			
Expenditures	43.4	49.5	55.0
Net lending	.1	-.6	(?)
Total	43.5	48.9	55.0
Tax expenditures	15.6	18.0	19.5
Total budget outlays plus tax expenditures	59.1	66.9	74.5
Tax expenditures as percent of budget outlays	36	37	36

¹ In the absence of the 10 percent standard deduction and most itemized nonbusiness deductions, the minimum standard deduction as presently structured would be taken by all taxpayers and its revenue cost would be relatively large. Under present treatment, the minimum standard deduction, in keeping with its objectives, is claimed almost entirely by low-income taxpayers and its revenue cost is \$300,000,000. The revenue estimate assumes the minimum standard deduction is designed to assist only low-income taxpayers. The minimum standard deduction is regarded in this analysis as related to the system of personal exemptions and thus a part of the structure of an income tax system based on ability to pay, rather than as a tax expenditure.

² Less than \$50,000,000.

Education and Manpower

Additional personal exemption for students.—Taxpayers may claim personal exemptions for dependent children over 18 who receive \$600 or more of income per year only if they are full-time students. The student may also claim an exemption on his own tax return, in effect providing a double exemption, one on the parents' tax return and one on the student's.

Deductibility of contributions to educational institutions.—Contributions to nonprofit educational institutions are allowed as an itemized nonbusiness deduction for individuals.

Exclusion of scholarships and fellowships.—Recipients of scholarships and fellowships may exclude such amounts from taxable income, subject to certain limitations.

TABLE 8.—EDUCATION AND MANPOWER

Tax expenditures (In millions of dollars)			
Additional personal exemption for students.....			500
Deductibility of contributions by individuals to educational institutions.....			170
Exclusion of scholarships and fellowships.....			50
Total.....			720
Budget outlays plus tax expenditures (In billions of dollars)			
	1968	1969	1970
Budget outlays:			
Expenditures.....	6.6	6.9	7.6
Net lending.....	.4	.3	.3
Total.....	7.0	7.2	7.9
Tax expenditures.....	.7	.8	.9
Total budget outlays plus tax expenditures.....	7.7	8.0	8.8
Tax expenditures as percent of budget outlays.....	10	11	11

Veterans Benefits and Services

All veterans pensions due to disability and those paid by the Veterans Administration due to age (over 65) are excluded from taxable income.

TABLE 9.—VETERANS BENEFITS AND SERVICES

Tax expenditures, 1968 (In millions of dollars)			
Exclusion of certain benefits.....			550
Budget outlays plus tax expenditures (In billions of dollars)			
	1968	1969	1970
Budget outlays:			
Expenditures.....	6.7	7.4	7.8
Net lending.....	.1	.3	(¹)
Total.....	6.8	7.7	7.8
Tax expenditures.....	.6	.6	.7
Total budget outlays plus tax expenditures.....	7.4	8.3	8.5
Tax expenditures as percent of budget outlays.....	9	8	9

¹ Less than \$50,000,000.

Aid to State and Local Government Financing

The Federal Government through certain tax provisions provides indirect assistance to State and local governments. The deductibility of property taxes on owner-occupied homes involving a revenue cost of \$1.8 billion is listed above under community development and housing as an element of the tax system which provides support to promote housing. This deduction also aids States and, particularly, local governments, by providing more flexibility in financing their expenditure programs.

Two other special tax provisions also aid State and local governments, but unlike the deductibility of property taxes on homes, they do not fit clearly within any of the functional categories now used in the budget. They are, therefore, shown as a separate budgetary heading, aid to State and local government financing.

In calculating income subject to tax, individuals may take as itemized non-business deductions State and local personal income, gasoline, sales, property, and other taxes. The deductibility of all these State and local taxes (with the exception of taxes on owner-occupied homes) on nonbusiness returns is classified as support for the finances of State and local governments, rather than listed under any of the functional categories in the current budget.

As a result of the exclusion from tax of State and local bond interest, these governments are able to sell debt obligations at a lower interest cost than would be possible if such interest were subject to tax.

The relative importance of indirect assistance to State and local governments through these provisions as compared with direct aid is not shown because the present budget does not show in a single functional category the aid given to State and local governments. The amounts of direct Federal aid by function, however, are brought together in *Special Analysis O* of the Budget for fiscal year 1970.

TABLE 10.—AID TO-STATE AND LOCAL GOVERNMENT FINANCING

Tax expenditures, 1968

(In millions of dollars)

Exemption of interest on State and local debt obligations.....	1,800
Deductibility of nonbusiness State and local taxes (other than on owner-occupied homes): ¹	
Individual income tax.....	1,350
General sales taxes.....	775
Gasoline taxes.....	400
Personal property taxes.....	150
Other taxes.....	125
Total.....	2,800
Property taxes on owner-occupied homes (included under community development and housing).....	1,800
Total, all State and local nonbusiness taxes.....	4,600

¹ For businesses owned by individuals, taxes other than income taxes are considered a cost of doing business and thus deductible in arriving at a net income figure.

Capital Gains—Individual Income Tax

The tax treatment of capital gains of individuals involves a large amount of tax expenditures. These expenditures would fall under a variety of functions in the Federal budget, including commerce and transportation, agriculture and agricultural resources, natural resources, community development and housing, and health and welfare. Available sources, however, do not provide a basis for accurate distribution among these functions. Thus, to avoid distorting any single category but to identify the importance of this special provision under the individual income tax, a new heading outside the budget classification is included for this item. Omission of this item leads to an understatement of the amounts of tax expenditures for the functional categories affected.

The types of special treatment accorded capital gains and the resulting tax expenditures are as follows:

If the owner of appreciated capital assets dies, the capital gains tax is not applied to appreciation which would have been taxable had he sold the assets just before death. Heirs who receive appreciated property from the decedent and who subsequently sell the property are subject to capital gains tax only on appreciation occurring after they acquired the property. Thus the appreciation on assets held until death is never taxed under the income tax. The revenue cost of this treatment is \$2.5 billion at present capital gains rates. (If taxed at full ordinary rates, the cost is \$4 billion.)

As to realized gains, half of the gains from the sale of capital assets held more than 6 months is excluded from income, and in no case is the tax rate applicable to such capital gains allowed to exceed 25 percent. The revenue cost of this treatment is \$4.5 billion. The revenue cost of this treatment at ordinary rates for both realized gains and gains untaxed at death is \$8.5 billion (including the \$4 billion mentioned above).

The cost of capital gains treatment under present law is complex for a number of reasons. It could be contended that:

1. Full taxation of realized capital gains, even with full taxation at death, could result in greater postponement of lifetime gains;

2. With a different treatment of capital gains another approach to the corporation tax might provide for some integration of corporate and individual taxes by giving taxpayers who sell corporate shares some credit for taxes paid by the corporation on retained income which is reflected in share values; and

3. Averaging of capital gains would lower the indicated revenue costs. In recognition of the complex issues involved, the tax expenditures involved in the present treatment of capital gains of individuals are placed in a range of \$5.5 to 8.5 billion. (No table is shown for this heading.)

IMPORTANCE OF TAX EXPENDITURES

The above analysis indicates that tax provisions control a large fraction of budget resources employed in several functional categories. With respect to commerce and transportation, for example, the volume of budget resources allocated by current special tax provisions is approximately the equivalent of budget outlays. In certain other functional categories, such as natural resources, community development and housing, and health and welfare, tax provisions constitute a major component of total Government activities.

Many reasons for the enactment of these tax provisions may be found other than the promotion of the functional activity under which they are listed, just as a multitude of forces affect the approval of direct Government expenditures which are nonetheless summarized under specific functional headings. This analysis in no way reflects on the wisdom of such reasons.

More efficient use of resources by the Federal Government is advanced, however, if explicit account is taken of all calls upon budget resources, including tax expenditures. The relative importance of different budgetary objectives can be more carefully weighed against all the budget resources used for this objective. Also, the effectiveness of alternative methods of achieving these objectives, whether through direct outlays, loan subsidies, or tax expenditures, can be fully understood, examined, and reevaluated periodically.

Secretary BARR. That concludes my testimony, Mr. Chairman, and I thank you.

Chairman PATMAN. Thank you very much, Mr. Secretary.
(Secretary Barr's prepared statement follows):

PREPARED STATEMENT OF SECRETARY OF THE TREASURY JOSEPH W. BARR

Mr. Chairman and Members of the Joint Economic Committee, I appreciate the opportunity to meet with this distinguished Committee. I think it extremely important that the members have the economic rationale for the financial plan President Johnson has recommended to the Congress—a plan that is responsible and realistic in terms of the country's needs and resources, and that is consistent with our responsibilities to keep the dollar strong and respected.

Before getting into the body of my remarks, I want to take a moment to pay tribute to you, Mr. Chairman, to the Vice Chairman, Mr. Patman, and to the members of the Committee. Under your leadership, the work of this Committee has contributed greatly to the tremendous growth of public interest in economic issues, to better informed public attitudes on economic policy, and to the record economic progress the United States has achieved.

The economy is now in the 95th month of the most sustained and vigorous period of economic expansion in our country's entire history. There is no need for me to enumerate here the many economic records established during this period of unprecedented prosperity. I believe that in his State of the Union Message and in his Economic Report to the Congress the President clearly established that the economy is now stronger and more vigorous than ever before, with production, employment, and after-tax income, including both wages and profits, all at record highs, far above the levels of a decade ago.

Chairman PROXMIRE. Mr. Surrey, thank you for a helpful, stimulating and thoughtful paper. This is most welcome. I think it is going to have a salutary and profound effect on Government operations over the next few years, this notion of making a conscious analysis of precisely what effect we have when we go ahead and proceed with the kind of tax concessions that you are talking about, and so forth. We haven't done that. We should do it.

I would like to even go farther than you go in your conclusion, when you say that it should be published as a special analysis. I would like to see two budgets, one budget with the expenditures as we have now, and then another budget including tax expenditures, to the extent you could do it. I suppose there would be some areas where you would have some problems. But to the extent you could do it, show exactly how much we are actually providing through expenditure and tax concession in these areas. You would get a much healthier and more thoughtful, more truthful analysis of our governmental impact, governmental programs, in that way than we get now.

I would like to ask about the mechanism by which direct expenditure policy is coordinated with tax expenditure in the executive department and especially in the Congress. Would you assign some sort of discretion over the level of tax expenditures to the Appropriations Committee, Ways and Means Committee? I would appreciate your comment on this.

Mr. SURREY. I suppose basically I feel that many of the tax expenditures should probably have been structured as direct expenditures in the first instance, and the tax route should not have been used for these activities. They are now, however, presently in the tax system and change involving them comes under the heading of tax reform, which is a very difficult matter compared to the appropriation process.

I think if we are to continue with the present system, there should be greater coordination between the two committees. For example, if the Ways and Means Committee feels that pollution control should have more funds spent upon it, it should coordinate that new with the regular committees of Congress and, in effect, say to them, "We are thinking of spending \$400 million for this item in this way. Will you give us your recommendation if that is the top priority, or should we stay away from this area and let you handle it through direct expenditures?"

It may well be that in some cases these tax expenditures could be phased out by indicating that after 2 or 3 years they will terminate, but the money will, in effect, be allocated by the budget to direct expenditures to be spent by the regular committees of the Congress.

Chairman PROXMIRE. Perhaps you would have something with pollution control where you would have the authorizing committee, which usually has the expertise, does the studies, and can do it in depth over a period of years, to provide the basic authorization, and then you would have to have some kind of coordinating mechanism between the Appropriations Committee and the Ways and Means Committee, in talking about the House, to determine what is the best and most practical way of channeling resources into this area.

Mr. SURREY. I would venture the guess—and this is on another matter—that when the committee studied it, it would find that the tax

system need not be used at all. In other words, there is really, in many of these cases, no need to use the tax system.

Chairman PROXMIRE. There is a political reason. It is a lot easier to cut somebody's taxes and say, "If you go ahead with pollution control we will give you a tax benefit," than it is to increase expenditures. From a practical matter, we say we have a high priority on pollution control. The President, for example, has just issued, I think, a very proper and desirable limitation on Federal construction, limiting it by 75 percent, and he was wise to do it, though I think it should have been more extensive than it was.

Under the circumstances, at this time it is hard to get action in this pollution control area which, of course, largely involves conservation and where I think most Americans feel we ought to have a high priority. One way you can do it quickly and smoothly, even though there is waste involved, is through the tax mechanism.

Mr. SURREY. It is not through the tax mechanism. It is through the willingness of the Congress to vote the sums through the tax mechanism.

Chairman PROXMIRE. That is what I say. You can go home to your constituents and say, "We gave you a tax break for a public purpose. You go ahead and serve the public purpose and you will be able to alleviate your taxes."

Somehow it is easier to sell that to constituents, I find, than it is to say, "We think we ought to spend \$400 million more."

Mr. SURREY. I am not sure which constituents you are talking about. The constituents receiving the benefits or the constituents in general?

Chairman PROXMIRE. It is a subtle thing. You are right. But, after all, if you vote for a \$400 million additional appropriation, it is easy for an opponent or critic to say that you are voting for more taxes. After all, you are, really.

On the other hand, if you vote for this tax concession, it has exactly the same effect. The critic could easily say this means that you are going to have to pay more in taxes, but he doesn't because you have this complicated problem and people just aren't perhaps that perceptive as yet.

Mr. SURREY. I think to some extent that may be true. I think, however, in many cases a lot of this is history and happenstance. In addition, of course, if one pushes that argument too far, it gives the Ways and Means Committee the control of all our social programs in the United States. With all due respect to the Ways and Means Committee, being a tax committee, they are not experts on all these social matters, just as that committee would not like the other committees to be injecting themselves in tax matters.

Chairman PROXMIRE. Would you agree that there are areas where it is desirable to have tax credits, where it is desirable on occasion to have at least a temporary benefit through taxes or achieve a social purpose through structuring your taxes? Or do you contend that in virtually all significant cases it is better to follow the appropriation route?

Mr. SURREY. I would suspect that in dealing with the range of social problems we are talking about today, in nearly every case it would be better to follow the regular appropriation process.

Chairman PROXMIRE. Let's take investment credit. I don't know what your position has been on investment credit. I would assume you favor its repeal now, but you may have favored its institution.

I myself favor it now. I think it really ought to continue. In any event, I can't imagine the Congress ever appropriating anything like \$3 billion for modernization of American plant and investment. I think it is a very desirable objective. Maybe we shouldn't have it now or maybe we should. That is something that I am not debating.

But we have had an enormous improvement since that was passed in 1962 for American investment in plant and equipment. We certainly wouldn't have anything like, as I say, \$3 billion a year, or \$1 billion a year, or \$100 million a year appropriated for that purpose.

Mr. SURREY. You may be quite right that the Congress wouldn't do it directly, although, interesting enough, in other countries they are more aware, I think, of what they are actually doing. The British, for example, had an investment credit and turned it into a direct payment, feeling that it could be handled better that way.

The investment credit, I think, is just about on the boundary line. In other words, it is a very simple sort of credit. You don't ask a fellow, when you give a credit for machinery, what kind of machinery it is. What purpose do you want it for, in what business is it being used? Any kind of machinery gets the verdict, and the Government is willing to write a blank check for any machinery in any activity.

In these other social programs, the Government is really not willing to do that. The Government wants a lot of controls. When the Government really wants to control the particular items upon which funds are spent, then there is really no need to resort to the tax system. It is only when the Government is willing to close its eyes and just write checks without asking about the purpose, activity, industry or anything else, then maybe you can say the tax system is better for administrative purposes.

Chairman PROXMIRE. In the course of your remarks, you say that the tax route doesn't have to be uncontrollable. You said it was uncontrollable, that the national debt depended upon the activity of the taxpayer.

Mr. SURREY. I am sorry. I meant the expenditures didn't have to be uncontrollable.

Chairman PROXMIRE. If you made it a direct expenditure instead of a tax expenditure?

Mr. SURREY. I said the amounts we are spending didn't have to be uncontrollable.

Chairman PROXMIRE. As long as it is a tax expenditure, you feel it is uncontrollable and hard to direct?

Mr. SURREY. It is hard to put a limit on the amount spent if it is spent through the tax system.

Chairman PROXMIRE. One of the characteristics of direct expenditure policy in the executive branch is that, some agency is supporting nearly every expenditure program in competition with every other program. Who would serve as the advocate for individual tax expenditures such as the tax exemption on State and municipal bonds? Wouldn't even good or desirable tax expenditures languish in such an environment?

Mr. SURREY. I don't think so. In a sense, who is concerned now about all State and local government matters? A lot of agencies of Government are. There is an interest in these matters in government and people would concern themselves with it. It isn't a question of the lack of people being interested in the matter. The Bureau of the Budget, the Advisory Commission on Inter-governmental Relations and others are all interested in Federal-State relations.

As the President's recommendations on revenue sharing indicate, people in the Federal Government are thinking about these matters. That is essentially an expenditure item and not a tax item.

Chairman PROXMIRE. What I had in mind was the tax benefits, for example, for housing that you suggest are very substantial. Shouldn't that be handled by HUD instead of the Treasury Department?

Mr. SURREY. Certainly. The Treasury Department really shouldn't be in this business at all. If suddenly half a billion dollars is going to be allocated under the tax system for housing, it would be far more rational in the Federal Government to tell HUD, "Here is \$500 million. How would you spend it? What are the priorities?"

HUD should be determining the priorities in these areas, that is, HUD and the congressional committees concerned with housing, and the Appropriations Committee, who, year in and year out, study these matters. The Ways and Means Committee does not study housing year in and year out. It does not study pollution control year in and year out. It does not study manpower training or any of these other matters year in and year out. These matters are studied under the congressional system carefully and well by the regular legislative committees of Congress.

Suddenly, and erratically, something shoots through the revenue committees and a large sum of money is suddenly spent without regard to all the studies and work in the legislative committees.

Chairman PROXMIRE. My time is up. I will be back. This is a good time for me to yield to Mr. Conable, a distinguished member of the Ways and Means Committee.

Representative CONABLE. I have been aware of Mr. Surrey's feelings on this before.

I am wondering, Mr. Surrey, really, if the tax expenditures are susceptible of very accurate measurement. The revenue lost through the tax preference doesn't necessarily accrue to the Government if the tax preference is eliminated. It does have a stimulative effect and, therefore, you can't really say there is an absolute dollar-for-dollar exchange, can you?

Mr. SURREY. Not in that sense, but that is equally true of direct expenditures. In other words, any time the Government spends so much directly, it has an effect on the economy, but we list the amount spent as a direct expenditure of Government. We don't offset that amount by saying we are spending x billion dollars on agriculture and then footnote this x billion dollars for agriculture spent as stimulating so much activity and so much revenue and, therefore, the net amount is so and so. We just list the x billion dollars as expenditures of Government.

Representative CONABLE. In other words, what you are saying is that we have the same problem of measurement in every case.

Mr. SURREY. That is right.

Representative CONABLE. If you are paying out agricultural subsidies, those may have the effect of creating more purchasing power in the hands of farmers, and, therefore, they may have more economic activity as a result of it, and, therefore, because there is more economic activity, some of the money expended may come back in additional taxes.

Mr. SURREY. That is right.

Representative CONABLE. This is a problem of economic measurement generally, and certainly the direct appropriation has superficially, anyway, a more accurate measurement simply in the budget document than anything that we can come up with in the way of an estimate of tax expenditures.

Mr. SURREY. I think the tax expenditure and the direct appropriation are similar in this regard.

Representative CONABLE. The problem I see is one of definition more than anything else. What about the low-income allowance? Is that a tax expenditure for the benefit of poor people?

Mr. SURREY. I would quite agree with you that the problem of definition is important. I did deal with that matter in part in my statement, and that matter is in part dealt with in the Treasury analysis.

Representative CONABLE. You can say that is a basic part of the tax structure now, assuming it is accepted—the low-income allowance.

Mr. SURREY. The Treasury analysis discussed these matters and said that essentially items that one would regard as a part of the basic tax structure would not be considered as tax expenditures.

For example, the rates of tax. Every income tax has tax rates. The same obtains as to exemption levels—the \$600 personal exemption would not be regarded as an expenditure. In other words, you would not say the tax system would generally have no personal exemption and, therefore, any exemption results in a tax expenditure involved. But, rather, exemptions are a feature of all income taxes, so to speak, and wherever Congress sets that exemption level, wherever it sets the rate levels, are parts of the basic structure of the tax system.

Essentially, what is involved here is a question of definition. What are the essential features of a tax system necessary to its function as an income tax, which is a tax levied on the income of people at certain rates and with certain personal exemptions, compared with features that have nothing to do with the measurement of net income for the purpose of an income tax. The boundary line will not be clear in all cases, but there will be vast areas on either side of the boundary line that are quite clear.

I would place the problem of definition, which you properly point to, in that perspective.

Representative CONABLE. My mind has been running over some of the areas of tax expenditure. Would you tend to favor, for instance, revenue sharing as opposed to the tax credit route for getting more money back into the States and localities?

Mr. SURREY. I regard revenue sharing as simply an expenditure of Government. It is just that the index happens to be a percentage of total income. I would equally regard such a credit for State and local taxes.

The Treasury analysis does regard the present deduction of State and local taxes by individuals as a tax expenditure in aid of State and local governments. The Treasury analysis has no problem in handling that matter. The question of which approach to assistance is better is a subject I would like to reserve for a later date.

Representative CONABLE. I quite agree that this kind of comparison of budget outlays and tax expenditures by function is a very desirable piece of information to have made readily available to the Government because it is noteworthy that in so many areas we have encouraged, through the tax structure, private involvement in the solution of problems, failing to note that it does involve, in effect, a Federal expenditure.

I think the Senator mentioned that there is a certain psychological and political problem in addressing all economic activity as though it were the function of the Government and, therefore, stimulative to devices which encourage private industry moving into areas of social concern. Lots of times that is more acceptable than the direct appropriation route.

We have to live in a political climate here and have to consider what is acceptable and what is not. I quite agree, though, that this analysis of the expenditures is a desirable thing.

Chairman PROXMIRE. Mr. Brown?

Representative BROWN. I have no questions, Mr. Chairman, except to support the idea that we know where the impact of tax legislation as well as direct appropriations lies. I think that one's view on this may be geared to whether you conclude that the wealth of the country is owned by the citizens of the country or whether it really is all for the use of the Government for meeting whatever the public needs may be.

I must say that I disagree with the philosophy that apparently lies behind the idea that tax credits are disadvantageous and that the money should be taken away from people and spent under Government direction rather than by encouraging them to spend it in ways that the Government feels are more beneficial to others.

Chairman PROXMIRE. Do you want to comment on that?

Mr. SURREY. Well, I do want to differentiate as Mr. Conable indicated. There are really two things.

The main thing I have been discussing here is the importance of having the information. As the Treasury analysis indicates, and the document submitted to your committee indicates, this is the information without any regard to whether the expenditures are good or desirable.

I think that the matter of information is the important question here. How one views the tax expenditures and how one views the tax system, here people can differ and have their various viewpoints. But the point would be that at least everybody would be able to discuss the matter, the same as with the direct expenditures.

People have different views as to direct expenditures, which are wise or which are unwise. But at least we know what is being spent under the direct expenditures and we can discuss that.

Essentially I am concerned here today with providing the information as to the tax system in a useful form on an annual basis.

Chairman PROXMIRE. One way of overcoming the irrational aspect of the reluctance to appropriate funds directly instead of using the tax expenditure route is to have it discussed, have it exposed, have it made part of a budget which people are aware of so they know how we are shifting resources into an area, whether it is community housing or whether it is pollution.

So I think that this appearance of yours this morning is a step in that direction. I think Mr. Brown has a very good point, that, after all, it is desirable to leave as much of the discretion to the citizen as we can in our presumably free enterprise system. We don't want to have the Government tax or spend any more money than is absolutely essential, at least I don't, and I think most of us in the Congress don't. I don't think you do either.

Mr. SURREY. That is right. I really don't want to take the time of the committee, but, if I did, I could go into that other matter, that is, that essentially, in a free-enterprise system, it doesn't necessarily follow that you have to use tax credits.

In other words, if you look at most of the incentive bills, and this is what people generally tend to overlook, in most of the bills—in the manpower training area, for example—everything has to be approved by the Secretary of Labor before you get your tax credit. You have to hire an eligible employee, certified by the Secretary of Labor. You have to be an eligible employer certified by the Secretary of Labor as having maintained certain wage standards, certain nondiscrimination standards, and the like.

After you get all these certifications, then you get your tax credit. But it is not basically necessary to the end result to say then you get your tax credit. You could equally say then you get a direct payment by the Secretary of Labor.

Chairman PROXMIRE. Then you have the element we haven't discussed so far, of not only the undesirability of a Ways and Means Committee or a Finance Committee which hasn't had the opportunity to go into depth here, because they have so many other things to do, but more importantly, perhaps, you have the tax collector branch of the Government acting to direct, supervise, influence an area in which they don't really have any real competence. Otherwise, instead, you should have the area which does have the competency to do it.

Mr. SURREY. That is correct.

Representative CONABLE. I think also you have to take into consideration the psychological factor. A lot of times people are willing to apply for tax credits who never would participate directly in a Government program. Therefore, the tax credit route may be more stimulative to the solution of the problem than the direct Government program simply because the prejudice some people have of dealing with the Government and their desire to minimize their taxes.

Mr. SURREY. I thought about that a great deal, Mr. Conable, because I have been trying to figure out whether it was a rational or irrational position.

Representative CONABLE. That doesn't matter if the prejudice is real.

Mr. SURREY. I think it is real because generally the tax credit mechanism is misunderstood. To a considerable extent, and just permit me

to say this, I think most businessmen have been misled in thinking about tax credits by the investment credit. To get that credit they didn't have to ask the Department of Commerce could they buy this machine. They just went ahead and bought the machine and got the credit. But if you will look at the various bills for tax credits for manpower training, that isn't the case. There the employer has to get the certifications of the Department of Labor. Businessmen think when they are using tax credits that they are not going to get enmeshed in Government bureaucracy, and that the hand of Government will not be upon them. But they don't read the bills carefully.

In all these bills for tax credits for housing that were in the Senate, the credits were for housing certified by the Secretary of HUD and the like, and the businessmen would all have to go down to HUD to get it all certified. So they are enmeshed.

I think they have been largely thinking of the kinds of tax credits we have had up to now, one the investment credit and you don't go to the Department of Commerce for that, and the other the foreign tax credit, and you don't go anywhere for that. But these new types of social tax credits that have been suggested are much more rigorously constructed because the people thinking about them are quite sensible. They want the kind of housing we need and they want the housing that is certified by HUD. So businessmen would be involved in Government bureaucracy. I don't think they appreciate the fact, but that is the way it would end up. At that point, whether they will still want the tax credits or not, I don't know.

We have run our whole space program and so on without tax credits—and successfully.

Representative CONABLE. A lot of people are tax-oriented that are not Government-contract oriented. There is no question about that.

Chairman PROXMIRE. Mr. Brown?

Representative BROWN. When you get into the pollution area, you can argue, I assume, you could force this investment simply by the impact of law, and require that somebody invest in this or close down, so that you don't have to give them any money directly or you don't have to give them any benefit through the tax credit approach. The reason, of course, for not doing that is that in many instances it would force the industry just simply to close down because they don't have the resources.

It seems to me that the reason for the tax credit approach being more desirable than the direct grant approach is that it gives the industry a little flexibility within its own operating requirements to make the decision when it wants to make it, and to make it to the extent that it wants to make it, in other words, to judge the amount of its resources it feels it can devote to this purpose.

Mr. SURREY. It doesn't work that way, Mr. Brown.

What you are saying is, essentially, I think correct. You are saying that in the pollution area people who build new plants are going to have to put in adequate features, and people who have old plants will put them in, generally speaking, under the force of the community concerned or a law, and this will be costly.

The question arises, should the Government assist these people in handling this cost? That is a perfectly legitimate question, and one

can answer the question, although I am not saying it need so be so answered: Yes; Government assistance should be given.

Having said all that, we come down to the particular question: How will the assistance be given? If you look at the current tax bill, which does give that assistance through 5-year tax amortization, the bill requires certifications by the various Government agencies concerned. You cannot get the tax benefit until the machinery has been certified and everything else. So the Government control is there. Once that control is there, I don't see the need to drag in the tax system. The certifying agency could say, "If you need assistance, we can write you the check." The check need not be written through the tax system by the Treasury Department.

Representative BROWN. But, again, it seems to me that you may be using the direct Government assistance to sustain an unsound economic unit in some way, whereas in the tax credit approach the economic unit has to be sound in order to sustain itself to start with.

Mr. SURREY. No, they both are the same in this regard.

Chairman PROXMIRE. Will you yield at that point? I think there is another argument on the other side. That is, by using the tax credit you may be subsidizing an unsound method. For example, as I understand, this would subsidize the use of equipment as compared with using a low-sulfur fuel, which might be by far the most efficient way of reducing pollution, but you don't use it because it is hard to write that into the tax law, the kind of fuel you get, as a tax credit.

So the tax credit would work to a misallocation of resources and an inefficient method of combating pollution.

Mr. SURREY. I believe you are 100-percent correct. That is one of the reasons that people have objected to the use of the tax system. It puts blinkers on, in a sense, and focuses the control of pollution only along the machinery route and does not, as you indicate, open up other vistas for use in pollution control.

Representative BROWN. It seems to me, in any event, that we have to look in Government, a long, long way down the road in tax law in addition to the direct appropriation route. I would cite the example of the railroads in this country which are in deep trouble because the depreciation laws, I think, basically, have not been considerate of the competitive developments that have occurred in the transportation area.

Both Government and the industry, I think, are at fault in this regard. In a way, the railroads have been living off of the original gifts that the Government gave them, which is the beginning, maybe, of this argument about how we are going to stimulate the developments that we think from the Federal level are economically beneficial to the country.

I think you have made some very interesting points in this area. I would suggest, however, that we are likely to continue to use both mechanisms whether we want to or not, and even whether we can write the laws soundly to do all the things that we ought to do. I think the point Chairman Proxmire made, relating to the inability to cover the use of fuels, is really a problem in the drafting of legislation. I think it could be covered legislatively, if you wanted to determine the extent to which you could charge off expenses for this particular kind

of fuel. I assume if you can change the rules with reference to taxes on investments, tax credits, that you can also make your tax laws read that the cost of a fuel being charged off against your taxes to the extent of three times its actual cost. Why not?

Chairman PROXMIRE. The Treasury worked hard on this. This was obviously a shortcoming in the law, and they just couldn't come up with an answer.

Mr. SURREY. I think you will find most people who worked in the pollution control area would give the tax route a very low priority for that reason.

Chairman PROXMIRE. When was the Tax Expenditure Budget first calculated by Treasury?

Mr. SURREY. The first calculation was in connection with the report for the fiscal year 1968. Therefore, the calculation was made during calendar 1968.

Chairman PROXMIRE. Was it opposed when it was first released?

Mr. SURREY. Opposed?

Chairman PROXMIRE. Yes, the Tax Expenditure Budget approach.

Mr. SURREY. I have not, myself, seen any criticism by anybody in Government of the analysis.

Chairman PROXMIRE. Were attempts made at that time to get it inserted into the budget document?

Mr. SURREY. There were discussions with the Budget Bureau, but my feeling is that the Budget Bureau feels it did not have sufficient time to consider the matter in depth along with its other problems.

Chairman PROXMIRE. Why, in your judgment, have these attempts been unsuccessful up until now, to get the tax expenditure budget inserted into the budget document?

Mr. SURREY. I think because of the newness of the matter. In other words, really the first time a careful analysis was made was in calendar 1968 in connection with the Secretary of the Treasury's report for fiscal year 1968. That was really the first time that anybody had before them a document which they could look at and say, "Does this stand the test of accuracy? Does it stand the test of economic validity and the like?"

I would say right now we are at the stage where we have this now. It was done a year ago, and people have looked at it. They can now consider the matter carefully as to including it in the budget.

Chairman PROXMIRE. What has been the reaction of the Bureau of the Budget to a revision of the budget?

Mr. SURREY. The Budget Bureau in 1968 essentially did support this whole approach. I think simply in 1968 there was not sufficient time at the end of the year when the budget was being prepared to consider its inclusion in that document at that time.

You do have a number of questions, such as the one you raised, should it be a special analysis or should it be included along with the regular expenditures and the like?

Chairman PROXMIRE. If you could have a part of this that was included, it seems to me it would arm us with a lot more useful material for floor debate and also in the committee. I am a member of the Appropriations Committee. If we should have this in the committee, we would be in a much better position to appraise exactly what we are

doing than if we have a special analysis tucked away that the experts look at but very few members of Congress, who are busy, as you know, and haven't a chance to look at it.

Mr. SURREY. That would be the ideal way.

Chairman PROXMIRE. You refer to the CONSAD cost-benefit study for the tax expenditures for oil and gas. What was the result of that study?

Mr. SURREY. That study was made for the Treasury Department and published by it. Essentially, the CONSAD study indicated that the Government is spending about a billion and a half dollars through the tax system on the oil and gas industry, but as far as the CONSAD study would indicate it was obtaining a very small amount in the way of actual additions to reserves.

I think it was in the ratio of spending a billion and a half dollars and getting only about \$150 million annually in the way of additions to reserves.

Chairman PROXMIRE. On that it would include the oil depletion, intangible drilling costs, and the other benefits?

Mr. SURREY. Yes, for oil and gas.

Chairman PROXMIRE. They are spending a billion and a half and getting about \$150 million in addition reserves?

Mr. SURREY. Which presumably is the reason why the billion and a half is being spent—to increase reserves.

Chairman PROXMIRE. They didn't spend that billion and a half in this way. Was there any consideration as to whether there was a more economic way? Would it be possible to increase reserves by a direct appropriation?

Mr. SURREY. The CONSAD study did not go into that, but one would think that there could be methods of direct expenditure that are more effective if it thought necessary to provide the assistance. It may be that the absence of \$150 million reserves annually is not a significant amount. Essentially, the CONSAD study indicates it is not a significant amount.

Chairman PROXMIRE. With what is going on in Alaska it especially pales into insignificance.

Mr. SURREY. Yes.

Chairman PROXMIRE. You say many of the tax expenditures are due to administrative rulings rather than congressional consideration. Can you give us an example of a tax expenditure occurring through an administrative ruling and about what portion of the tax expenditures are accounted for by administrative rulings rather than congressional decisions?

Mr. SURREY. I can't answer the last, though it is an interesting question.

For example, the current deduction of intangible drilling expenditures started off as an administrative ruling, and it only became a legislative matter much later after a court decision cast doubt upon it. But for most of the period of time it was simply a ruling by the Internal Revenue Service way back in the early history of the income tax, that you could expense or capitalize intangible drilling expenses.

Chairman PROXMIRE. It is an enormous benefit to the oil industry, and it was just a matter of a ruling by somebody in the Treasury De-

partment that that was their interpretation. But there was no explicit statutory justification?

Mr. SURREY. I don't want to say no explicit statutory justification because I would have to go back and analyze the matter. But it was certainly not viewed as being bared on any necessity to develop our natural resources, and should money be spent in the public interest for this purpose? I think it was more a matter of administrative convenience, of handling the accounting.

Equally, most of the agricultural problems that are being discussed now in the tax reform bill grow out of a ruling by the Internal Revenue Service that farmers, no matter how large their inventories, can be on the cash method of accounting and need not capitalize certain expenditures. But that is a ruling of the Treasury Department. It is not a statutory matter.

In time, the revenue involved in these rulings grows to very large amounts, but it is not perceived at the time that the ruling is made because the focus is on administrative matters.

Now all these items are defended as being necessary for the survival of this or that industry when originally, of course, that was not even in question. It was just a technical tax question.

The excess bad-debt reserves of banks is an Internal Revenue Department ruling, not a statutory matter at all.

Chairman PROXMIRE. I just have a couple of other questions, but they are questions that really intrigue me.

The first one is: Some people have referred to price expenditures in the same context as tax expenditures. Price expenditures are described as actions taken by the Government which directly affect the price paid by a consumer and, hence, affect spending patterns and resource allocations.

For example, the oil import quota results in a higher price for gasoline and fuel oil, and so forth, and because people spend more because of the oil import quota, you get more resources flowing into this particular industry.

Do you see any analogy between price expenditures in that sense and tax expenditures? Do you see any possibility of altering—I don't want to go too far on this—altering the budget document to include price expenditure data as well as that on direct expenditure and tax expenditure?

Mr. SURREY. I just don't think I ought to venture an opinion on that. It is not my field, and I have not thought about it. In a sense you are also talking about custom laws and so forth.

Chairman PROXMIRE. We have all kinds of testimony from experts as to how much the oil imports are costing the American consumer, and it is billions of dollars a year.

Mr. SURREY. I am aware of the hearings that are going on in other parts of Congress with respect to this matter. I think I will just leave it there, not being an expert in that particular program. I have not reflected on the point you raise, that price expenditures may be another aspect that should be looked into.

Chairman PROXMIRE. This committee especially, it seems to me, should be interested in that, because no other committee would really have the kind of overall interest that we would have. It seems to me this committee could make another useful contribution.

You have direct appropriations, tax expenditures, and then you have price expenditures, which are brought about by Government action of this kind.

I was fascinated by your assertion that the Federal Government spends more on commerce and transportation through the tax system than by direct expenditures, \$9.7 billion relative to \$9 billion.

Could you elaborate on how you arrive at this estimate?

Mr. SURREY. The significant item there in the tax expenditure aspect would be the investment credit, but I could just list a few of these to give you a sense of what is involved.

Chairman PROXMIRE. That would be only part of it. The investment credit for everything is only \$3 billion. This is \$9.7 billion.

Mr. SURREY. Some of the other matters that are listed are the deductibility of interest on consumer credit, \$1.3 billion, personal interest; the corporate surtax exemption for small business, which is \$1.8 billion; the dividend exclusion, \$225 million; excess depreciation on buildings, \$500 million; expensing of research and development expenditures, \$500 million. These are some of the big items involved in the total.

Chairman PROXMIRE. In your judgment, do the objectives served by these tax expenditures tend to contradict or complement direct expenditures in the same categories?

Mr. SURREY. I think in many cases they contradict direct expenditures. For example, take the case of housing. As far as one can tell from the direct expenditures, the basic interest of Government in the housing area is in low-income housing. That is what we are directly spending money on.

Chairman PROXMIRE. Except the FHA, of course, has had a far more substantial influence in middle- and upper-income housing. They almost exclude low-income housing.

Mr. SURREY. I am talking about rental housing, not owner-occupied housing, and other buildings. Let me put it this way. The only interest the Government has generally in subsidizing buildings has been in low-income residential rental housing, leaving out the owner-occupied area. But through the tax system, we spend about \$1 billion on all buildings. That tends to take labor, take investment, and so forth, and crowd it or push it all into the building area generally, and make that area attractive, where, through the direct expenditures, we are trying to induce people to put their money into low-income rental housing.

We are working at cross-purposes in the whole building area by spending far more on office buildings, motels, and shopping centers, through the Government mechanisms, than low-income housing.

Chairman PROXMIRE. Here is an example where a breakdown or specificity in your analysis would be useful, just to know that the tax expenditures are contributing to housing not being very useful.

But if we knew that it was contributing in a kind of cross-purpose and shifting resources from where they are needed most to where they are not needed, and where you cannot make a case on the basis of equity that you have to have it, it seems to me would be most useful to the Congress in correcting this unfortunate point.

Mr. SURREY. Really, in many of these tax expenditure areas there has been no cost-benefit analysis of the kind you are indicating, which

ought to be made. Once the expenditures are listed, then my guess is there would be these analyses, the same as have been those developed with respect to direct Government expenditures.

Chairman PROXMIRE. Thank you very, very much, Mr. Surrey. You have done a wonderful job. This is most interesting and useful to us. We deeply appreciate your coming before us.

Mr. SURREY. Thank you.

Chairman PROXMIRE. The subcommittee will reconvene on Friday of this week to hear Mr. Charles Zwick, former Director of the Budget, and Mr. Lee White, former Chairman of the Federal Power Commission. That will be in this room.

(Whereupon, at 12:30 p.m., the subcommittee recessed, to reconvene at 10 a.m., Friday, September 19, 1969.)

ECONOMIC ANALYSIS AND THE EFFICIENCY OF GOVERNMENT

FRIDAY, SEPTEMBER 19, 1969

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON ECONOMY IN GOVERNMENT
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Subcommittee on Economy in Government met at 10 a.m., pursuant to call, in room S-407, the Capitol, Hon. William Proxmire (chairman of the subcommittee) presiding.

Present: Senator Proxmire and Representative Conable.

Also present: John R. Stark, executive director; Robert H. Have-
man and Richard F. Kaufman, economists; and George D. Krumb-
haar, minority economist.

Chairman PROXMIRE. The subcommittee will come to order.

The problem of inefficiency, unresponsiveness, and waste in Govern-
ment is one of the most serious problems confronting this society. Tax-
payers see their income siphoned off in high taxes and spent on un-
productive programs by many in the bureaucracy who know little of
the need to be cost-conscious in dealing with the public trust. The poor
and minority groups see the wealth of the Nation used to subsidize the
largest and most powerful corporations and line the pockets of the
most wealthy of their stockholders.

Consumers see Federal rulemakers who have an economic stake in
the decisions they make and regulatory bodies which are infected with
the views of the very sector they are to regulate. It is on this waste,
subsidization, inefficiency, and unresponsiveness of Government which
this set of hearings is spotlighting.

It is not "paper clip" waste with which we are primarily concerned.
It is program waste—the use of vast amounts of national resources for
unproductive and low-priority purposes. It is the problem of a Govern-
ment which fails to change priorities when circumstances and dem-
ands change. It is the basic question of the right of a Government
to command a part of the income of its citizens to be used for purposes
which fails to meet their demands, for purposes which would be
rejected if they were more fully understood.

During the hearings of the subcommittee on both the military budget
and the planning-programing-budgeting system, the enormity of waste
and the lack of cost-consciousness in the Government has been repeat-
edly impressed upon us. Experts from many fields pointed out how
up to \$10 billion could be eliminated from the military budget with
no loss of national security effectiveness. Inconsistencies in program

evaluation in other areas imply that equivalent waste is to be found in the nonmilitary budget.

Moreover, recent information on Government rulemaking and revenue policy indicates that these areas also involve significant shifts of resources of wealth which are uneconomic and inequitable. As Senator Goldwater testified in encouraging this subcommittee to take a more comprehensive look at Federal policy :

I believe there is no excuse for waste and inefficiency in any area of Government, whether it is in the procedures and practices which have grown up in the Pentagon or in expenditures for highways, schools, and hospitals.

America has led the way in developing new technologies and in increasing the productivity of its labor and capital resources. As Servan-Schreiber has pointed out, the American genius to invent, innovate, and apply new technologies has made this Nation the challenge of the entire world.

It appears, however, that this spirit of innovation has so far been limited to the private sector. No one has recorded any comparable challenge forthcoming from the effectiveness and efficiency of Government. In the public sector we have lagged in developing and funding programs which respond to new social needs and international realities, we have lagged in applying the techniques of modern management and decisionmaking to public policy matters; we have failed to correct the program errors which we made in past years; we have not brought analysis and information to bear on decisions when such knowledge was available; we have failed to root out those programs with obsolete missions, and we have let major subsidies to vested interests stand unchallenged.

In this set of hearings, we are continuing our concern with priorities and efficiency, begun with our study of the military budget. We are placing the spotlight of economic analysis on the full range of direct expenditure, "tax expenditure" and rulemaking policies, and ask if what we are doing is worth the candle.

The practices of the regulatory agencies as well as policies in the areas of pollution control, medical care, maritime and aviation policy, irrigation, flood control, and navigation expenditures, urban development, and aid to higher education policy will all be studied by the subcommittee.

Hopefully, through this investigation we can develop proposals for increasing the role of economic analysis in securing an efficient, responsive government.

Today, we are honored to have as our first witness Dr. Charles Zwick, formerly Director of the Bureau of the Budget.

Dr. Zwick received his B.A. degree from the University of Connecticut and his Ph. D. in economics from Harvard University. Prior to his service in the Federal Government, Dr. Zwick taught at Harvard and spent several years as a research economist at the Rand Corp.

From 1964 to 1968, he served at the Bureau of the Budget, concluding his stay there as Director. He has authored several articles on economics and an important volume on transportation economics.

Dr. Zwick, we are delighted to have you, and you may proceed with your statement.

**STATEMENT OF CHARLES J. ZWICK, PRESIDENT OF SOUTHEAST
BANCORPORATION, MIAMI, FLA.**

Mr. ZWICK. Thank you, Mr. Chairman. It is a pleasure to be here to talk on a subject of major importance. This committee is making a major contribution with these hearings.

Your earlier hearings have laid out the history of PPB in Government. I will not attempt to retell this history today, but I would like to make an observation, and that is that a system does exist. It is not perfect—it has many problems—but a system does exist and some significant budget improvements have occurred because of that system.

Let me first start by talking about the several roles of analysis, and I think the plural here is important. The traditionally assigned role for analysis is to display the impact of Government on policy objectives—in the technical jargon of the economist, relating inputs to output measures.

Stating this function simply, it is asking the right questions about a program. What are we trying to accomplish? How effective is program A compared with program B in meeting these objectives? What are the costs of alternative courses of action?

Good analysis by definition answers these questions.

A second, and I would argue equally important role for analysis, is to serve as an irritant, as an instrument of change in a system dominated by inertia.

In this capacity, analysis is used as an instrument by those who want to reorder program priorities and expenditures. By questioning program objectives and effectiveness and basing their inquiries on "expert analysis," partisans have found analysis a useful ally in accomplishing predetermined policy objectives. In fact, it is currently unthinkable to enter a major public policy debate without a full cadre of experts and extensive analyses to support one's point of view.

A third and I think also important role of analysis is that it affects the level at which decisions are made within the executive branch of Government. Typically analysis has been portrayed as neutral with respect to where decisions are made within a bureaucratic structure.

This is simply not true. Analysis, by making explicit assumptions and rationale which were in the past implicit, or unstated, has made it possible for higher echelons of the executive branch to participate in these decisions. Whether one views this as a useful development depends, of course, on one's position. As the old saw goes, "Where one stands on an issue in Washington depends on where he sits," is unfortunately more true than we like to admit.

Because of the PPB system, agency heads have been able to increase their control over their subordinate units. My assessment of this event was that they applauded it. Agency heads appreciated their increased ability to control their subordinate units. But they did not applaud the possibility of the Executive Office of the President increasing its control over their agencies. Similarly, those of us who toiled in the Executive Office of the President were sure that our increased ability to participate in agency decisions was clearly desirable, but we always questioned whether or not all this information should be made avail-

able to Congress, so that it could participate more effectively in these decisions. Simply stated, analysis does affect the level at which decisionmaking can take place, and therefore plays an important third role. It is simply true that decisionmakers at various levels of Government are guided by different objectives and different criteria.

Just a few words on the limits to analysis. These are well known. First and most obvious is that it can be misused to prove a point with partial, incorrect, or fabricated data. In this aspect it is no different from any other technique of debate.

Also, analysis can be expensive in both time and money. Relative to public policy decisions at stake, the amount of money spent on analysis might be small but time is always an irritant. Impatient people cannot wait for analysis, they demand action.

It is also true—and this is a point I would like to underscore—that good analyses are usually partial in nature. They illuminate one, or at most, a few aspects of a problem but do not deal with all facets. This is good analysis technique but not adequate for the needs of most public policy decisions in this rapidly changing world. It is rarely possible for an analyst to anticipate all the issues that will be relevant at the time a policy decision is made.

But the most important limiting aspect of analysis is that it is highly dependent on the objectives—outputs—that one specifies. Most of the important policy issues go directly to program objectives.

I will indicate two examples. It is necessary or desirable that a significant portion of our export trade be carried in U.S. bottoms? Much of the debate about maritime policy stems from different conclusions about this objective. Do we believe that users of the airway system should pay for the cost of the system, or should the airways be the responsibility of the general taxpayer? These are illustrative of very basic policy objectives. The assumption one makes about these objectives will shape dramatically the structure and results of an analysis.

Perhaps the most important conclusion to reach in face of these limitations of analysis is an oft-stated truth; namely, that analysis can be helpful but is not a substitute for tough-minded decisions on the part of responsible public officials. Stated another way, analysis will never substitute for political backbone. Analysis can be an ingredient and help provide backbone, but in the end, analysis cannot substitute for difficult public policy decisions.

You have asked me to outline areas in which progress can be made. The key area at this point in history is congressional interest. If and only if the Congress takes interest in these analyses will they flourish within the executive branch of Government. Agency heads are busy, harried individuals who will listen to those people within their organizations who can get an appropriation bill through Congress. If the Congress shapes the dialog by demanding appropriate analyses to support assertions by the executive branch, the agency head will immediately show more interest in program analysis. If on the other hand Congress carries out its review of programs and appropriations with inadequate data and in an out-of-date committee structure, the role of analysis within the executive branch is immediately depreciated.

Lest it appear that my objective is to place all responsibility for lack of future progress on the Congress, let me quickly take some

responsibility here. Those of us who were involved in the early days of the PPB system were so preoccupied with internal executive branch problems and interfaces that from time to time we forgot that there was a legislative branch of Government.

I am sure you gentlemen think we forgot it more than we did but it is clear that from time to time we forgot there was a legislative branch of Government.

There is another old pro in the executive branch who kept reminding me during those days that "somebody beside us must like the system, and I mean by that, the Congress. We have to come to terms with Congress or the system will not be effective in the long run." The Congress and the executive branch have yet to come to terms on this issue.

Simply stated, congressional interest and capacity are absolutely essential to major advances in the executive branch of Government, because of this interaction between congressional interest and the focus of the senior officials in the executive branch.

A second major area for improving analysis capability of the Government is additional work on the distributional impact of programs. In brief, how does the program affect various regions and client groups? Most analyses have ignored these issues.

Economists, in particular, like to emphasize the efficiency aspect of a program, ignoring the distributional impact of program changes. If I learned anything in my three and a half years in Washington it was that Members of Congress are very much concerned with distributional impact. How does it affect their constituents in particular, and more generally, given their basic political orientation, what groups are favored and what groups are disadvantaged by a special course of action?

The distributional impact of policy changes should be a standard requirement for an analysis effort. In the excellent volume the committee produced earlier this session, Professor James T. Bonnen of the Michigan State University discusses this problem and points out that it is almost impossible to find data on distributional impacts of Federal programs. But until analyses provide information on this issue, they will continue to be politely received and then set aside as not completely relevant to the serious business of congressional decisionmaking.

A third area that I would like to emphasize is the need for hard work on the "small decisions" of Government, in contrast with the "big decisions." We give more publicity and more attention to big policy decisions, including major public works activities, new programs, and the procurement of major systems than we do the hundreds of small decisions involved in running the Federal Government.

There is certain logic to this emphasis, but it is also true that hundreds of small decisions add up to significant sums of money. For example, President Johnson's 1970 budget included \$46 billion of compensation for both military and civilian personnel. Trying to decide whether "division Y" in "bureau B" needs 100 or 80 people seems small relative to some of the important policy issues facing the Congress. But a 20-percent difference in personnel costs across the Government would provide budget elbow room of close to \$10 billion. As

another example, consider the Defense budget. Almost half the Defense budget is devoted to maintenance and operating expenses. Again, better utilization of Defense Department resources can have a major impact on Defense budget requirements. Individually small improvements do add up to very large savings.

Let me in closing highlight these points with several specific examples.

First, analysis as an irritant and a shape of the decisionmaking dialog. This committee and the Bureau of the Budget have been attempting to get a more uniform, more appropriate interest rate policy implemented within the Federal Government. One of the 1969 reforms that we did accomplish was a step in this direction. Notice that I say "step," rather than complete accomplishment. I must frankly admit that at the time I did not think we would get away with that one small step.

What really happened was that the opposition said, "All right, we will allow them to estimate costs of a project using a higher, more realistic interest rate, but we will open up a new avenue of attack, namely the inclusion of secondary benefits in the analysis. If we up benefits by the amount costs have been increased, no harm has been done." The benefit-cost ratio will be exactly the same as it was before.

I would argue that we made progress because we have moved the dialog from an old basis to a new basis, and in that movement hopefully we make some progress toward more efficient public works decisions. The secondary benefits argument must be addressed, but we have irritated the system; we have caused a change in the dialog and I am enough of an optimist to believe that some progress will result.

Almost every major policy issue I can think of is highly dependent on distributional considerations. The proposed tax reform package, for example, goes directly to the issue of who should pay the tax bill of the Federal Government. The impact of the tax policy on long-term economic growth and stability questions seems to a distant observer to be receiving less attention.

The issues surrounding our air traffic control and airport system are not so much issues of whether or not we need additional facilities as who should pay the cost of these necessary systems—the general taxpayer or the users of the system?

The use of publicly owned resources is another area heavily influenced by distributional issues. Should the users of the public range, for example, pay a fair market value for this right as executive policy dictates, or should it be leased at less than fair market value as a direct subsidy to specific regions and industries? Should the timber activities of the Federal Government be shaped by policies which ignore the geographic income distribution from this public resource, or should they be used as a subsidy to specific areas?

My experience has been that the use of publicly owned resources is heavily influenced by distributional issues. To be relevant to decision-making in this area, analyses must explicitly spell out distributional effects.

The question of increased congressional involvement remains. Perhaps the time has come to create a commission on the appropriate role and limits of analysis in the development of public policy. A commis-

sion could be created by congressional action or by Presidential initiatives. If the commission is to be successful, it must include representatives of both the legislative and executive branches of Government. Nongovernmental members should include both technicians and other individuals with experience in Government.

Hopefully, such a commission would define a framework for the support and the use of analyses focused on public policy decisions. High on my list of concerns for the commission would be the issue of privileged information. This highly important matter should not be left to the partisans whether they are in the executive branch, Congress, or are technicians. Research workers, for example, have a bias for complete disclosure. This problem alone will tax the best judgment of the commission members and is the key to furthering the role of analysis in public policy formation.

I am normally suspicious of commissions, but I believe the time is now appropriate for this one. Diverse congressional guidelines concerning analysis exist and are proliferating. In the Corps of Engineers we have Congress directing specific studies and directing that they be made in what I believe to be a biased fashion. New appropriation bills are having riders attached to them every day. The whole issue of executive privilege here it seems to me needs to be looked at in a fundamental way, and if we can make progress here, I think we will have taken an important next step.

A commission would be a logical followup to the recent Commission on Budget Concepts, which was highly successful. To digress for a minute, I want to applaud the current Secretary of the Treasury and the Budget Director for sticking to their guns.

I know they are under a lot of pressure to back off from the new, unified budget concept, because if we went back to the old administrative budget we would show a deficit rather than a surplus. I think the unified budget was an important step in the right direction, and I am delighted to see that they are sticking to their guns on this one.

But if you look at the report of the Commission on Budget Concepts, probably the most unsatisfactory part of that Commission Study was a chapter on the publishing of information. Dialogs, Senator Proxmire, that you and I have had in the past on making available information to the Congress about what we really think expenditures are going to be for the next year are relevant here. The administration has just come out with a new summer review.

Many of these issues have not been addressed and agreed upon as a procedural matter, and I do think the time has come when a commission, if properly structured, could make an important contribution. I believe you have to have both legislative and executive branch members on it, plus nontechnicians to give this question of privileged information a broader perspective.

My testimony this morning has been very simple and brief; I did this deliberately. The issues here are fairly simple, not complex. The issue is overcoming inertia, and this is, of course, always a difficult matter. I will be happy to try to answer any questions.

(The prepared statement of Dr. Zwick for inclusion in the record follows:)

PREPARED STATEMENT OF CHARLES J. ZWICK

Mr. Chairman and Members of the Committee: It is indeed a pleasure to have an opportunity to appear before you today. The subject under consideration is clearly important. My observations are based on a three and one-half year tour in the Bureau of the Budget and also my efforts as a research economist prior to joining the Bureau.

The history of program analysis in the Federal Government is well documented and I do not propose to recount it today. Several facets of this history are important to my remarks. First, despite failures and frustrations, the ability of the executive branch to carry out competent analyses has developed significantly over the last eight years. Increased emphasis on analysis, first in the defense department, and then in other parts of the government with the introduction of the Planning, Programming, and Budgeting System (P.P.B.) has, in fact, influenced markedly budget making in the executive branch. This is not to deny that major improvements remain to be made, but to highlight a fact that sometimes is lost in our concern with improving the system.

A system exists and it will not go away easily. The highest compliment I have heard concerning the progress made since the introduction of the P.P.B. system on a governmentwide basis in 1965 is a comment made by one of those celebrated old bureaucrats who said to me roughly a year ago, "I have been looking at the progress of this system. It has now been established in various departments and agencies, and I have concluded that it will not go away by itself; it will take a major effort to completely discredit and eliminate its influence on decisionmaking within the executive branch." This is high praise indeed because we are talking about a fundamental reshaping of the decisionmaking process. Such revolutions take time and are necessarily painful.

THE SEVERAL ROLES OF ANALYSIS

It is important to recognize that analysis plays several roles in policy formulation and program execution. First, its traditionally assigned role is to display the impact of government action on policy objectives—in technical jargon relating inputs to output measures. Stating this function simply, it is asking the right questions about a program. What are we trying to accomplish? How effective is program A compared with program B in meeting these objectives? What are the costs of alternative courses of action? Good analysis by definition accomplishes this important task.

A second, and an equally important role for analysis, is to serve as an irritant, an instrument of change in a system dominated by inertia. In this capacity analysis is used as an instrument by those who want to reorder program priorities and expenditures. By questioning program objectives and effectiveness and basing their inquiries on "expert analysis", partisans have found analysis a useful ally in accomplishing predetermined policy objectives. In fact, it is currently unthinkable to enter a major public policy debate without a full cadre of experts and extensive analyses to support one's point of view.

The increased stress on analysis has also had an important effect on the level at which decisions are made within the executive branch. Typically analysis has been portrayed as neutral with respect to where decisions are made within the bureaucrat structure. This is simply not true. Analysis, by making explicit assumptions and rationale which were in the past implicit, or unstated has made it possible for higher echelons of the executive branch to participate in these decisions. Whether one views this as a useful development depends, of course, on where one is temporarily housed within the bureaucratic structure. The old saw that "where one stands on an issue in Washington depends on where he sits" is unfortunately more true than we like to admit.

Because of the P.P.B. system, agency heads have been able to increase their control over their subordinate units. They applauded this development but agency heads have been reluctant to see the Executive Office of the President increase its control over their agency. Similarly, those of us who toiled in the Executive Office of the President were sure that our increased ability to participate in executive branch decisions was clearly desirable, but we always questioned whether or not all this information should be made available to congress, so that it could participate more effectively in these decisions.

Stated simply, analysis does affect the level at which decisionmaking can take place, and therefore plays an important third role. It is simply true that decision-

makers at various levels of government are guided by different objectives and different criteria. By altering the level within the bureaucratic structure at which decisions are made, public policy is affected because different levels of the system place varying weights on the several criteria that are relevant in major policy decisions.

In summary, an increased emphasis on analysis has shaped the dialogue involved in governmental policy making in three distinct ways. These are:

By changing the format for displaying program information.

By serving as an irritant or vehicle to overcome inertia.

By changing the level within the executive branch where decisions are made.

THE LIMITS TO ANALYSIS

It is appropriate to pause at this point and briefly highlight the limitations of analysis. The first and most obvious is that it can be misused to prove a point with partial, incorrect, or fabricated data. It is no different in this respect than other techniques of debate.

Analysis can also be expensive in both time and money. Relative to the public policy decisions at stake, the money spent on analysis might appear small, but the time element is always an irritant. Impatient people cannot wait for analysis; they demand action. And it is also true that most good analyses are partial in nature. They illuminate one or a few aspects of a problem, but do not deal with all facets. This is good analysis technique, but not consistent with the needs of most policy decisions in this rapidly changing world. It is rarely possible for an analyst to anticipate all the issues that will be relevant at the time a policy decision is made.

But the most important limiting aspect of analysis is that it is highly dependent on the objectives (outputs) that one specifies. Most of the important policy issues go directly to program objectives. It is necessary or desirable that a significant portion of our export trade be carried in U.S. bottoms? Much of the debate about maritime policy stems from different conclusions about this objective. Do we believe that users of the airway system should pay for the cost of the system, or should the airways be the responsibility of the general tax payer? These are illustrative of very basic policy objectives. The assumptions that are made in an analysis about these objectives will shape dramatically its structure and results.

Perhaps the most important conclusion to reach in face of these limitations of analysis is an oft-stated truth; namely, that analysis can be helpful but is not a substitute for tough-minded decisions on the part of responsible public officials. Stated another way, analysis will never substitute for political backbone. Analyses can be an ingredient and help provide backbone, but in the end, analysis cannot substitute for difficult public policy decisions.

To provide a specific example, we hear much about the need to reorder priorities, to cut out the less important programs, and to proceed in a more focused budgetary manner. On page 22 of the 1969 budget that President Johnson submitted to congress, more than a dozen program reforms were proposed. Almost two years later, only two have been adopted; one by executive branch action; the second through legislation. The others were too tough; they involved hard choices which the congress was not prepared to make. I would argue that analysis was not inadequate in these cases; I doubt if more analysis would have changed the record. Analysis can provide relevant information, but it cannot provide political courage or will.

AREAS WHERE IMPROVED PERFORMANCE IS NEEDED

You have asked me to outline areas in which progress can be made. Let me start by suggesting that a key area is congressional interest. If, and only if, the congress shows interest in these analyses will they flourish within the executive branch of the government. Agency heads are busy, harried individuals who will listen to those people within their organizations who can get an appropriation bill through congress. If the congress shapes the dialogue by demanding appropriate analyses to support assertions by the executive branch, the agency head will immediately show more interest in program analysis. If, on the other hand, congress carries out its review of programs and appropriations with inadequate data and in an out-of-date committee structure, the role of analysis within the executive branch is immediately depreciated.

Lest it appear that my objective is to place all responsibility for lack of future progress on the congress, let me quickly take some responsibility here. Those of us who were involved in the early days of the P.P.B. System were so preoccupied with internal executive branch problems and interfaces that from time to time we forget that there was a legislative branch of government. There is another old pro in the executive branch who kept reminding me during those days that "somebody beside us must like the system, and I mean by that, the congress. We have to come to terms with congress or the system will not be effective in the long run." The congress and the Executive Branch have yet to come to terms on this issue.

I will not be foolish enough to tell this committee how to provide the needed congressional reform. These hearings, of course, are one vehicle, but I believe you would agree that a great deal remains to be done in terms of congressional interest. My objective in raising this issue is not to reveal new truth about congressional habit, but to point out that congressional habit and style affects significantly procedure in the executive branch. Because of this interaction between congressional style and executive procedure, I believe the next major effort must be to develop a congressional capability to demand and exploit analyses. Short of this congressional interest and capability, major advances will not be made in the executive branch of government.

A second major direction for improving analysis capability of the government is additional work on the distributional impact of programs. In brief, how does the program affect various regions and client groups? Most analyses have ignored these issues. Economists, in particular, like to emphasize the efficiency aspect of a program ignoring the distributional impact of program changes. If I learned anything in my three and one-half years in Washington, it was that members of congress are very much concerned with distributional impact. How does it affect their constituents in particular, and more generally given their basic political orientation, what groups are favored, and what groups are disadvantaged by a specific course of action?

The distributional impact of policy changes should be a standard requirement for an analysis effort. In the excellent volume this committee produced earlier this session, Professor James T. Bonnen of the Michigan State University discusses this problem and points out that it is almost impossible to find data on distributional impacts of federal programs. But until analyses provide information on this issue, they will continue to be politely received and then set aside as not completely relevant to the serious business of congressional decision making.

A third area that I would like to emphasize is the need for hard work on the "small decisions" of government, in contrast to the "big decisions". We give more attention to big policy decisions, including major public works activities, new programs, and the procurement of major systems than we do to the hundreds of small decisions involved in running the Federal Government. Although there is logic to this emphasis, it is also true that hundreds of small decisions add up to significant sums of money. For example, President Johnson's 1970 budget included 46 billion dollars of compensation for both military and civilian personnel. Trying to decide whether "division Y" in "bureau B" needs 100 or 80 people seems small relative to some of the important policy issues facing the congress. But a 20% difference in personnel costs across the government would provide budget elbow room of close to 10 billion dollars. As another example, consider the defense budget. Almost half the defense budget is devoted to maintenance and operating expenses. Again, better utilization of defense department resources can have a major impact on defense budget requirements. Individually small improvements do add up to very large savings.

It is important that we improve our capability to analyze small program requirements such as the number of people needed to carry out specific jobs. This is not glamorous work; it is expensive and time consuming work. The potential benefits are great, however.

A FEW ILLUSTRATIONS

In closing, I would like to highlight these points by specific examples. First, analysis as an irritant and a shaper of the decision-making dialogue. This committee and the Bureau of the Budget have been attempting to get a more uniform, more appropriate interest rate policy implemented within the Federal

Government. One of the 1969 reforms that we did accomplish was a step in this direction. Notice that I say "step", rather than complete accomplishment. I must frankly admit that at the time I did not think we would get away with it. What really happened was that the opposition said, "All right, we will allow them to estimate costs of a project using a higher more realistic interest rate, but we will open up a new avenue of attack, namely the inclusion of secondary benefits in the analysis. If we up benefits by the amount costs have been increased, no harm has been done." I would argue that we made progress because we have moved the dialogue from an old basis to a new basis, and in that movement hopefully we make some progress toward more efficient public works decisions. The secondary benefits argument must be addressed, but we have irritated the system; we have caused a change in the dialogue and I am enough of an optimist to believe that some progress will result.

Almost every major policy issue I can think of is highly dependent on distributional considerations. The proposed tax reform package, for example, goes directly to the issue of who should pay the tax bill of the Federal Government. The impact of the tax policy on long term economic growth and stability questions seems to a distant observer to be receiving less attention.

The issues surrounding our air traffic control and airport system are not so much issues of whether or not we need additional facilities as who should pay the cost of these necessary systems—the general tax payer or the users of the system? The use of publicly owned resources is another area heavily influenced by distributional issues. Should the users of the public range, for example, pay a fair market value for this right as executive policy dictates, or should it be leased at less than fair market value as a direct subsidy to specific regions and industries. Should the timber activities of the Federal Government be shaped by policies which ignore the geographic income distribution from this public resource, or should they be used as a subsidy to specific areas? My experience has been that the use of publicly owned resources is heavily influenced by distributional issues. To be relevant to decision-making in this area, analyses must explicitly spell out distributional effects.

As I have already indicated, small unglamorous changes in the operations of specific bureaus, divisions, and agencies when accumulated across the government can have a major impact on total government spending.

I believe there should be increased congressional interest in making such changes. To give only one example, the question of how frequently aircraft sub-systems should be inspected might appear mundane. The answer to the question, however, determines how many maintenance personnel are needed by the Air Force. Since roughly one out of every three people in the Air Force are involved with maintenance, even small improvements in efficiency can have tremendous leverage on costs.

I hope these brief remarks have served to highlight several issues that must be addressed if significant progress is to be made. The question of increased congressional involvement remains. Perhaps the time has come to create a commission on the appropriate role and limits of analysis in the development of public policy. A commission could be created by congressional action or by presidential initiative. If the commission is to be successful, it must include representatives of both the legislative and executive branches of government. Non-governmental members should include both technicians and other individuals with experience in government.

Hopefully, such a commission would define a framework for the support and the use of analyses focused on public policy decisions. High on my list of concerns for the commission would be the issue of privileged information. This highly important matter should not be left to the partisans whether they are in the executive branch, congress, or technicians. Research workers, for example, have a bias for complete disclosure. This problem alone will tax the best judgment of the commission members and is key to furthering the role of analysis in public policy formulation.

I am normally suspicious of commissions, but I believe the time is now appropriate for this one. Diverse congressional guidelines exist and are proliferating. The recent commission on budget concepts was highly successful. A commission on the uses of analysis would be a logical next step to that effort. If well reasoned, its report could provide a broad framework in which all parties can exploit the insights gained through competent analysis.

The examples I have given in this testimony are by design limited and simple because I believe the underlying requirements for progress are not complex. Overcoming inertia is of course another matter. I have enjoyed this opportunity and will be most happy to answer any questions you may have.

Chairman PROXMIRE. This is a very fine statement, Dr. Zwick. It is useful because you have come up with constructive proposals here that have a lot of merit.

I would like to ask you first, when you say, "Perhaps the most important conclusions we reach in face of the limitations of analysis is an oft-stated truth; namely, that analysis can be helpful, but it is not a substitute for tough-minded decisions on the part of responsible public officials."

In our debate on whether or not to go ahead with the fourth squadron of the C-5A, that is whether to buy an additional 23 of these giant cargo planes in addition to the 58 that we already have authorized, I raised the point that there have been two studies in the Office of Systems Analysis, which is in the Office of the Secretary of Defense, both of which say that the fourth squadron would not be cost effective, that we should not buy it, one of which was made in November, November 7 of last year, one was made on June 11 of this year.

Regardless of the question asked by the Secretary of Defense, or the Assistant Secretary in charge of systems analysis the study came up with no. Yet the Secretary and Assistant Secretary in charge of systems analysis turned down both those studies, and decided we should go ahead with a fourth squadron.

I suppose you could say that this was a tough-minded decision but I might call it something else, tough-minded, hard-headed or knot-headed. Whatever it is, it was a decision which seemed to contradict the only studies they had made of the wisdom of whether they should go ahead with C-5A.

Under these circumstances, I just wonder if there is any recourse that Congress can have, where you have a study, and it is turned down, what do you think we ought to do? This involves this executive privilege argument, too.

Mr. ZWICK. Yes.

Chairman PROXMIRE. It was a secret study made for the Secretary of Defense. It was a kind of interoffice thing. The Secretary of Defense was cooperative. He sent his people up and they told me honestly what the study showed. I think I might have been able to ask for a secret session of the Senate and we could have brought the studies up and examined them in detail.

I do not know whether that would have gotten me any more votes against the C-5A or not.

Mr. ZWICK. Without commenting on the last part of that question as to whether it would have gotten you any more votes, let me respond to this general issue by first quoting another sentence of my testimony and then talk about it.

"It is rarely possible for an analyst to anticipate all the issues that will be relevant at the time of a policy decision."

Now, I would presume in this case the Secretary of Defense considered other issues that were not in the analysis, issues that he weighed in reaching a conclusion. What can you do about it? I think

the most important thing Congress can do about it is ask him what these issues were. They can be explicit as to what are the criteria.

Chairman PROXMIRE. We did. The first study they claimed that they did not need them because these were only really necessary in an emergency, and by flying these 58 planes 15 hours a day, using them intensively, you would not need the additional 23. The 58 could do the job. They argued that 15 hours a day was not realistic.

Well, they permitted this whole study to go on on the basis of an assumption which they were going to reject later as unrealistic.

The second answer was the same kind of thing. They made assumptions as to the availability of other transport, the availability of prepositioned material and all that kind of thing. Then when the whole study was completed they said well, these were very optimistic assumptions, that all these things would be available. "For that reason we are not going to use the findings of this study."

So it looks as if they will make a study and if it satisfies their preconviction, their initial policy position, they will use it. Otherwise they will just reject it.

Mr. ZWICK. I put this under the heading of "Analysis as an Irritant."

Chairman PROXMIRE. One of the things that Secretary Laird suggested to me the other day was he said Congress ought to have its own Office of Strategic Systems Analysis. How about that?

Mr. ZWICK. Well, this goes to this whole question of executive privilege. It is part of it.

Chairman PROXMIRE. Couldn't we have our own? Do you think it would be practical?

Mr. ZWICK. My guess is that you are going to have to have more capability than you now have. I think that is too easy an answer just to say you should have your own unit. Obviously some data that the taxpayers are paying for that is done in the executive branch should be made available to the Congress so that you do not have to do it all over and rediscover at double the cost what we have already paid for.

There are other data that I would suspect will continue to be privileged in nature, and if that is the case Congress should have a capability to reach conclusions independently, and test the executive branch in what is after all an adversary proceeding between the executive and the legislative branch. Therefore, I think you need additional capability, but I would like somebody to do a better job than I have seen done to date in sorting through what should be privileged, what should not be privileged.

Complete disclosure runs I think a very serious risk of cutting off studies.

Chairman PROXMIRE. That is what the Secretary—

Mr. ZWICK. I think if you demanded that everything be turned over to your committee, then you would start finding things done on the back of envelopes.

Chairman PROXMIRE. That is why I wonder why we should not have an independent operation. I understand the Secretary's viewpoint. He said, "You are going to kill this office if you insist on these reports." He said, "How can I ask for them to make a good tough study and come up with a position that may contradict the Joint Chiefs, may

contradict other very important people, maybe even the President's position, how can I make that kind of a study if you are going to grab it and use it on the floor to upset our position?"

Mr. ZWICK. That is right.

Chairman PROXMIRE. And I see his viewpoint. On the other hand, we want to come to the right decision on these things.

Mr. ZWICK. I think the final solution does have a significantly increased congressional capability, independent analysis. I do think there is an important issue as to whether we duplicate everything, and I think that would be an equally bad decision. It seems to me there is some set of terms, some set of data that the Government should only pay for once, and that should be freely interchanged between the executive and legislative. But when it gets down to sensitive policy issues, I think the Secretary of Defense stated it correctly.

If you insist on seeing every one of those studies, then those studies will not be made, which I think will be a step backward.

Chairman PROXMIRE. Now why shouldn't we require some kind of a finding, some kind of a benefit-cost ratio on almost all of these decisions? What I am referring to is this.

We have on the floor of the Senate now the NASA appropriation, and I wrote to NASA and asked them to give me the justification for the additional nine manned landings on the moon, and they gave a general reply about how it would help communication—how it would help meteorology, help earth resource studies and so forth. I said specifically tell me exactly what benefit they will give in all these areas. The only thing they could come up with, No. 1, it will help our self-fulfillment, our human fulfillment, which means we feel better when we watch it on television.

No. 2, it will give us the answer or a clearer answer on the formation of the moon and the earth and the sun.

No benefit, they come up with none, not one single benefit for any human being on earth, in the area of health, in the area of a better life, in the area of a more abundant life nothing, no benefit at all.

So the benefit-cost ratio here is infinity in reverse.

It seems to me that if we could have something like this on these things, we would have a saner—we could still go ahead and say well, we want it because circuses and bread are great, but here we have a program which is going to cost us \$1.7 billion for the Apollo part of the space program. I am not talking about the rest, which perhaps is desirable.

I have not seen any cost-benefit study of any part of this. But here you seem to have an area, an effort which was going to give us no benefit at very very great cost, simply because there is kind of a momentum and a glamour that has been built up behind it. Wouldn't it be helpful if we could insist on analysis in all of these areas where we are spending say well over \$100 million?

Mr. ZWICK. I could not agree more. I would put it though in terms of shaping the dialog, asking what are you trying to accomplish. Just the examples you have used this morning, Senator, seem to me to make the point very well. In this case they could not give you very explicit, very persuasive objectives, and that allows you as an elected official to make a better judgment about the NASA program.

In the case of C-5A, they were forced to start questioning assumptions about the utilization of aircraft and so forth. Once they start in that direction, the dialog is shaped in a particular fashion. These are honest disagreements about 15 hours versus 12 hours of utilization.

Again, this shaping of the dialog I think improves the ability of the Congress to make decisions. I am not persuaded that we are going to come up with a nice round number like 3.25, and that is better than 3.20, but by forcing the executive to display, make explicit the assumptions, the rationale, you have a vehicle to cross-examine them, and form your own opinion.

Now, This is much better than the old style that national security is involved, intelligence is involved, the veterans program is involved, atomic energy is involved.

Chairman PROXMIRE. Of course I am biased because I lost the vote on the C-5A, but I think it was the old arguments that really prevailed.

Mr. ZWICK. That is right.

Chairman PROXMIRE. But I do hope that maybe as we get into this, and get more and more of this new kind of analysis you are talking about, the old arguments would not always prevail, that we will be able to establish a position based on—I am sorry; my time is up.

Mr. Conable?

Representative CONABLE. It is nice to see you, Dr. Zwick.

Mr. ZWICK. It is good to be back, but not before the Ways and Means Committee as Budget Director.

Representative CONABLE. You know, I listened to the discussion about analysis, and it gives me a feeling of anguish about the extent to which Congress is able to surround a great deal of analysis. We are somebody's neighbors sent down here to participate in decisions of Government which are becoming increasingly electric and requiring greater and greater specialization. The effort of achieving some sort of balance between our responsibility of operating in very broad areas of public policy and yet understanding increasingly specialized economic and other governmental data is a pressing burden for a Representative who is trying to look after a half million people as they want to be looked after at the same time. I do not really see where we are headed on this.

It is very obvious that analysis is desirable, and yet I do not read a quarter of what comes across my desk now, and I just have not been able to resolve in my own mind this very very difficult burden of finding a constructive balance.

With that philosophical concern expressed, I would like to ask you something more specific. You refer to "out-of-date committee structure" with regard to appropriations. I do not want to put you on the spot, but I suppose you are no longer on the official spot anyway. This is a particular concern of mine here in Congress. Would you care to specify what you are referring to with respect to, "an out-of-date committee structure."?

Mr. ZWICK. Well, first, Mr. Conable, you are correct in your observation. Eight months ago I would not have said it, and I thought twice about saying it even in this context, because if I was not prepared to say it then, why should I say it now.

Clearly, the split that worried all of us over the last several years is between the Ways and Means Committee and the Appropriations Committee; the taxing and the spending split is in a broad sense what I am talking about. More narrowly, I think I am talking about the question of who is doing the appropriating and how do you package appropriations. We always have to cut it up, because everybody cannot sit down, as you said in your opening statement, and worry about all problems, so you have to package parts of the budget, and presumably there are some ways of packaging that are better than others.

I think you are finding the appropriations process now really undergoing significant changes. You are having, for example, the Ways and Means Committee getting involved; it certainly did involve itself in the tax bill by putting an expenditure ceiling as a requirement for getting the surcharge through.

You are finding the authorization committee going more and more to annual authorization procedures as a vehicle of getting into the appropriations process, so you are getting an appropriations process through the annual authorization. This is clear in the Armed Services Committee and now in other committees.

Third, you are getting authorization committees through a series of devices, putting automatic expenditure requirements, and this starts with the trust funds, the social security trust funds, which in reality the Ways and Means Committee appropriates. It includes the highway trust fund, and more recently in the Vocational Education Act last year the Education Committee put in a rider which made it impossible for the executive branch of Government to hold back any education funds, so that you are putting in automatic expenditure devices in various and sundry ways to protect special programs, and at the same time there is an expenditure limitation.

Now when you say those two things at the same time, you are essentially cutting back on some programs, the ones that are still available to be cut back on, so that I think you do have, in a very fundamental way, some reshaping of responsibilities in the Congress.

I do not want to get in the middle of how it should be done, because, first, I am not competent, and even if I was competent it would be inappropriate. But this whole process is what I am getting at. Until you have committees where you are looking at a meaningful set of programs and then also you have a committee that is interested in asking, "What are you trying to do and how this program may accomplish that," I despair that additional analyses will do much to improve decisionmaking.

Representative CONABLE. Would you agree that analysis has more relevance to the work of the Bureau of the Budget than it does to Congress? Isn't our role more the tough-minded decision than the sophisticated understanding, and therefore isn't the wave of the future with respect to analysis more the province of the Budget Bureau?

Mr. ZWICK. No, I think I would disagree on two grounds. Mr. Conable. First I will restate my earlier argument specifically to the Budget Bureau. There is a limit to how much an agency head will take the directives from the Budget Bureau to do good analysis and support their arguments, if he believes that that is a side show that he has to carry on with the Budget Bureau, and to get an appropriation through his subcommittee structure in Congress he has to play another game.

As long as he thinks he has to play two games he keeps his eye on the ball which is to get the appropriation through Congress and he will do whatever he has to do to get the Budget Director off his back, but that is a minimum input as far as he is concerned. He is busy, has got lots of things to do, and while he may even be intellectually interested in this sort of thing, he just does not have time for extraneous things.

So if Congress says "we are not interested," the Budget Bureau cannot be effective. They just cannot command the attention of the executive branch.

The second point I would make is that the Budget Bureau is identical to the President as your staffs are to you. Certainly you are not going to have time to go through these analyses, but hopefully you will have staff which is competent and capable either in your own staff or in your committee structures, who can do the analysis, or check the analysis, and then give you some briefings on the broad issues at stake and what the answers are. In that sense, the idea of the President sitting with a console in front of him doing analyses I think is inappropriate, and it is inappropriate to assume that Congressmen are going to have time to sit down and do it.

You ought to have an independent capability somewhere in legislative branch to help you, to boil down the tons of material.

Representative CONABLE. It is part of the process of an effective check.

Mr. ZWICK. Certainly.

Representative CONABLE. Or balance between the branches of the Government.

Mr. ZWICK. Yes.

Representative CONABLE. I am persuaded more and more that one of the most reactionary, one of the most conservative forces in the world is the bureaucratic function. I have recently read Henry Kissinger's book on foreign policy, and have noted his comments about the extent to which the demands of large-scale organization tend to slow down the governmental process, to make it considerably more difficult to arrive at decisions largely because of all the input of analysis that comes up through the bureaucracy to the point of decision. It certainly tends to eliminate capriciousness in the process, but it tends also to eliminate responsiveness.

Mr. ZWICK. That is correct.

Representative CONABLE. And again it is a question of how you achieve a balance between the need for information and the need for decision. I applaud your reluctance about commissions, and I note that you suggest the establishment of another one here.

Mr. ZWICK. Yes.

Representative CONABLE. Do you think this commission should be a permanent one?

Mr. ZWICK. No. I think I would propose just the opposite. I would give it a relatively short deadline, and by that I mean 12 months or something like that. I really believe, and I am patterning this on the Budget Concept Commission, which I think did a useful service and made a useful contribution because now Secretary Kennedy drove that commission to a result in less than a year. If you make it permanent, it will just bog down and get nowhere.

Commissions are usually established when you do not know what else to do. It is a holding action. You do not really want it to report. I do think—and if you will look at the proliferation now of guidelines, congressional guidelines on how analyses will be done—we are at a point where this is an important issue.

As I say, you start with the Corps of Engineers, where the Congress in that case directs the executive to carry out an analysis of a specific project, and report back, and in the Department of Transportation legislation, Congress went even further and said, "You will carry out that analysis using these techniques," techniques which I happen to disagree with, but nevertheless in terms of procedure Congress is saying, "Do a study and do it using these techniques and report the answers in this fashion."

At the other extreme you have analyses that the taxpayers have paid for in the drawers of the officials in the executive branch, who do not want to make them publicly available. I suspect they go too far in the other extreme. In between you have an area in which I am frankly unclear, where I would head, if I had to sit down and think hard about it for several months, as to what should be privileged to the executive.

You had in the Economic Opportunity Act of 2 years ago, a requirement that the executive produce a 5-year program for eliminating poverty. We never complied with that request, and as far as I know, it is still sitting in Mr. Rumsfeld's desk drawer.

You may remember on January 17 of this year the sharpest debate I had when appearing before this full committee was between Mr. Rumsfeld and myself on this question, and he was very much on the side of putting everything in a wheelbarrow and bringing it up here to the committee to take a look at, and I was arguing the other side.

You might even ask Mr. Rumsfeld how he perceives this problem, now that he is down in the executive branch.

I am saying that I think there is a genuine interest here of looking at this question of where analysis should be done. Should the GAO do it for the legislative branch? Should the individual committees have the staff? How much of it should be duplicative of what the executive has done? How much of the executive information should be passed on to the Congress?

I think that a statesmanlike group, recognizing the diverse interests involved, could come up with a useful statement but I think you will want to say do it within 12 months at the longest, or it will bog down.

Representative CONABLE. My time is up.

Chairman PROXMIRE. I like this commission idea, because we have got to do something it seems to me to get Congress in on this operation.

Mr. ZWICK. Yes.

Chairman PROXMIRE. We are going to be operating at a great disadvantage and are going to do a much less satisfactory job until we can begin to use this. So if this is not the device I want something else. Could you state the precise questions you would have the Commission answer, or as closely as you can generally?

Mr. ZWICK. Well, first, I would like it to have a philosophical prolog, if you will, about the roles of analysis and the limitations of it, because there tends to be something mystical about analysis. I do not happen

to believe that. There are people working hard with certain points of view.

I think I would start with where should it be carried out. I do not think I would get into the committee structure of the Congress. That is too difficult and it will bog down. But should the Congress have a capability, and if so, is it an institute type organization reporting to the whole body, or is it analysis capability in the various committees? Is it the GAO?

Then I would address the issue of common data. How much of the data should be generally available? Should the analysis be done in one place or the other?

Chairman PROXMIRE. In view of the fact that this is largely a legislative effort what would be wrong with introducing a bill and let the Government Operations Committees of the two Houses handle it?

Mr. ZWICK. I would assume that is the appropriate place to do it.

Chairman PROXMIRE. I mean rather than a commission making a study have the Government Operations Committees decide how to go ahead with this.

Mr. ZWICK. Well, again I think if you could focus attention on this for a short period of time, and get some really broad gaged people to look at it, you might get a useful result. Otherwise I think if you do it in the everyday course of business, it may bog down and we may never hear of that commission again.

I am just trying to provide focus attention in trying to get the job done in a reasonable period of time.

Chairman PROXMIRE. Now to get at the background of this I would like to ask you about the attitude of those who say economic analysis is designed for improvement of the Executive. As a byproduct it can be used to buttress the alternative shown by the Congress.

This is the attitude that the more information analysis the Executive can keep from Congress the less trouble it is going to have running the Government the way it wants without interference of Congress. There is that attitude.

Mr. ZWICK. That is right.

Chairman PROXMIRE. And it comes up quite often. It depends of course upon the particular Secretary involved or what not.

Mr. ZWICK. Certainly.

Chairman PROXMIRE. In your statement you imply much the same state of affairs and argue that Congress should have more access to policy analysis. Do you feel that Congress should know the 75 or 100 issues on which the Budget Bureau is requesting agency analysis?

Mr. ZWICK. If you say should we send up the special list of issues—

Chairman PROXMIRE. Let me ask it this way—

Mr. ZWICK. At this point I think—

Chairman PROXMIRE. Do you think Congress should have access to program memoranda?

Mr. ZWICK. Let me just go back one step further and say that statement you read was almost a paraphrase of what one Secretary said to me as Budget Director, so it does go all the way up the line. The Secretary said PPB was a great device. He knew more about running his department than he ever knew before but when he came before the

Budget Bureau he came as a partisan and he came as an advocate of a program, and he was not going to make available to the Budget Bureau all the options they looked at and they discarded. And then we had essentially the same attitude. We should participate. We are all part of the same administration. We should look at these things. But we had our doubts about how much of it should be passed to Congress to take a look at.

Again, and I am trying to be biased on the side of making as much available as possible, I am sure that is my bias, I think it you required that that specific list of 75 studies be hand delivered on a certain date, then it would shape the types of studies that the Executive, the Bureau of the Budget would ask of the agencies.

If it becomes a public document, the issues addressed would be more timid, more conservative. There would be more rationalization of existing policy.

Chairman PROXMIRE. Then are you saying we should not have the program analysis?

Mr. ZWICK. My snap reaction would be that I would not want you to have those specific lists. On the other hand, it would be quite appropriate, it seems to me, for you to ask the Budget Director to come up here and outline what areas they are exploring within the Executive. You would then have some idea of what they are concerned about and why they are concerned about these areas. You may want to do some independent analysis, or you might want to wait for their analysis.

I think as a general proposition, if you said, "Show me those 75 studies in this work statement," you would inhibit the Executive. It is in this area where I am trying to come up with a sensible definition. You have every right to know what is concerning the Executive and they ought to be asked to explain this.

I think if you demand to see the specific work statements, you will destroy their usefulness.

Chairman PROXMIRE. It is a tough one to resolve.

Mr. ZWICK. That is right.

Chairman PROXMIRE. I think we need to do a lot more thinking here.

Mr. ZWICK. That is right.

Chairman PROXMIRE. Because obviously you are inhibiting Congress now.

Mr. ZWICK. That is right.

Chairman PROXMIRE. We are not getting the information we ought to have, we are not making intelligent decisions. At least we do not know what the agencies have done. They have the manpower, they have the competence, the professionals who go into this, and they just do not give us the alternatives, and their considerations for debate, so we cannot come to conclusions.

I hope that you can give us maybe in the future some idea of this.

I think you understand the dilemma very well.

Mr. ZWICK. Certainly.

Chairman PROXMIRE. You are a former Budget Director. You are in an ideal position, and you are not Budget Director now, which I think is helpful.

Mr. ZWICK. Yes, from many points of view.

Chairman PROXMIRE. I think it is helpful in this situation where you can speak certainly with more objectivity than if you were the Budget Director now and you would have in your mind "I do not want these fellows to know this, that, or the other thing."

I would like to ask do you feel that Congress should have unsanitized versions of special analytic studies? I presume the answer to that is also reluctant?

Mr. ZWICK. No; I would make a distinction between special analytic studies, and now that we are getting into jargon, my view of what a special analytic study is—is a piece of analysis that should be made available.

The 5-year program memorandums where you are getting into program options and administration policy is the sticky one. I would have the analytic studies made available; at least sanitized versions of them.

Chairman PROXMIRE. How would you evaluate the desirability of this arrangement? No. 1, Congress as a matter of routine would be furnished the list of issues to be analyzed each year. I take it that you are reluctant about that.

Mr. ZWICK. I would be perfectly happy, I believe, to sort of give you areas of interest, but the specifics of the work statement I think would inhibit the executive.

Chairman PROXMIRE. Then No. 2, all program memorandums and special analytical studies would be filed by the Budget Bureau with the General Accounting Office.

Mr. ZWICK. I would be opposed to that.

Chairman PROXMIRE. But you would go along with special analytic studies being available to Congress?

Mr. ZWICK. Correct.

Chairman PROXMIRE. But not the program memorandums?

Mr. ZWICK. Right.

Chairman PROXMIRE. No. 3, upon request of a congressional office GAO would provide a synopsis, interpretation, and evaluation of any special analytical study. You would go along with that?

Mr. ZWICK. Yes.

Chairman PROXMIRE. But not with the kind of—

Mr. ZWICK. I do not like the emphasis of this whole sequence. It sort of makes the GAO second guessers, and I would like to make GAO a little more participant in this, and have an analysis capability and do some of its own analysis. It is always nice to be a second guesser in this business and we all like to be in this position, but I have observed that in fact it is not usually the most productive way to proceed.

Chairman PROXMIRE. We would have an awfully big GAO then, wouldn't we?

Mr. ZWICK. I would have a different type GAO than we have now. I really believe that the GAO has been somewhat reluctant to move in this area because it is not sure Congress wants to move in this area, and I would say Mr. Staats is a really practiced operator in this town. He is probably reading Congress better than I can read Congress' mood in these matters.

Chairman PROXMIRE. Let me give you the last part of this since it is put together thoughtfully. No. 4, where the release of privileged in-

formation is involved, GAO would notify the Bureau of the Budget of the request. In those cases in which the Bureau felt release of the privileged information was contrary to the national interest it would state in writing the reasons for its decision.

I take it because you would be reluctant to have the material even if it were not classified released, you would feel that this was something—

Mr. ZWICK. Yes; this is one procedure trying to get at making more of this data available. I am perfectly sympathetic with the objective here. I doubt some of the specifics and I doubt in general the complete piggyback approach, if you will, of the legislative on the executive will work. I just think that in any dialog there has to be some counter-analyses on the part of the legislative that tests the executive branch analyses.

Chairman PROXMIRE. The problem we have, of course, is that the committees of Congress are supposed to be doing this with their staffs. The committee do become pretty much the kind of an interest group in a way.

Mr. ZWICK. That is right.

Chairman PROXMIRE. I mean they are men of great integrity and ability but they do identify themselves with the program, the Space Committee with the space operations, Armed Services Committees with the armed services, Agriculture with agriculture, and they are not really as critical as they might be. I was hopeful with this kind of analysis that maybe we could have a basis for challenging the formidable problem we have of keeping these things under control, where everybody wants to get more of the public resources.

Mr. ZWICK. I understand the objective. I think I am in complete sympathy with it. I have some question about the specifics of the procedure, but that is quite a bit of agreement before we get to the specific disagreements.

Chairman PROXMIRE. Are you familiar with the program study of the Office of Program Evaluation of the Bureau?

Mr. ZWICK. The program—I should be but the semantics just do not ring a bell.

Chairman PROXMIRE. This is a study that identifies each program with the benefit-cost ratio and the distribution effects?

Mr. ZWICK. Yes. In fact it was this set of data that Mr. Rumsfeld and I discussed at great length last January.

Chairman PROXMIRE. Then do you think that the results of this study should be released by the Congress on an annual basis?

Mr. ZWICK. Well, I argued then and what has happened since January 17 I do not know, but on January 17 I argued, and I would argue today it would be a mistake, because this is a first attempt at developing a procedure, the numbers which were used in that procedure, in fact, they had them footnoted as fairly hard or completely made up something like this phrase. I thought it was a laudable first attempt at getting at these issues, but it was so imprecise, so approximate, to be thrown into the debate on the floor of Congress would have been I think a perfect example of how you are going to kill off analyses which may be good, so I was against it then and I would be now, if it has not improved significantly, and I doubt if there is that much progress been made since then, I would be against making that available.

Now down the road that is an objective we are heading for.

Chairman PROXMIRE. And you think we ought to make it available eventually?

Mr. ZWICK. That is right.

Chairman PROXMIRE. But not until it is improved.

Mr. ZWICK. Until you have some confidence in the thing. This is where we are all heading, so, again, I am not disagreeing with the objective. I am making a judgment though as to whether you will do more harm than good.

I think there is a broader public policy issue of what is executive privilege and what is not, and I am not comfortable. I have thought a lot about this, and I do not have an easy solution for you. On this specific issue I would argue against making these analyses available at this point in time.

Senator PROXMIRE. On Tuesday in the last testimony before this committee in this series, Stanley Surrey argued that the tax expenditure budget should be made a regular part of the budget document, so that you show, for example, the involvement tax credit would be shown as an expenditure?

Mr. ZWICK. That is right.

Chairman PROXMIRE. For the modernization of plant and so forth. I wonder if you agree with that?

Mr. ZWICK. Yes, I do agree. In fact we almost had it in this year's budget. The reason we did not was that we ran out of time. If you remember, as we came down to the wire there was a question of whether there would be an extension of the surcharge recommended or not, and that sort of overwhelmed all of us, but we had plans and in fact there are galley proofs around that would have been part of the special analysis.

I think it is terribly important to put these things in a publicly available place so that people can look at them.

Chairman PROXMIRE. You would put them in the appropriate department. For instance, he argued that in some areas, housing, for instance, you have twice as much tax expenditure as you have actual budget appropriations.

Mr. ZWICK. That is right. The way you display them in the budget document is something that I might disagree with Mr. Surrey about, but not the fact that it should be in the budget document, so that it is available for analysis as you say. In many cases the tax expenditure is greater than the direct expenditure, and that should be available.

Chairman PROXMIRE. Then what would be your answer to the argument that he made that improved evaluation would result if tax expenditures were stated explicitly in the budget of the agency to which they are most closely related?

Mr. ZWICK. I agree with that.

Chairman PROXMIRE. But you would not just lump them in?

Mr. ZWICK. I am thinking about the overall summary table for HUD and I would not want to have that over-table. For the purposes of Congress you want to know direct expenditures that you have to appropriate. You also would like to know in the case of HUD how much this tax-expenditure calculation is, so I am sympathetic with

its basic objective and I think we are only disagreeing about the format.

Chairman PROXMIRE. He also argues that the PPB system should be expended to include tax expenditures rather than the direct expenditures. Do you agree with that?

Mr. ZWICK. Yes, I certainly do. As I indicated earlier, there is a big drive to make significant parts of the budget automatic and therefore not subject to review, and that goes all the way from tax expenditures to trust funds to strictures in education bills, saying that the executive branch cannot withhold any of these funds to revenue-sharing. Revenue-sharing is just the opposite of this hearing, which says these moneys will be expended without any review by the Congress. The question which you have to face, do you want to make automatic expenditures or do you want to review them. I think the general thrust of this committee is close review and scrutiny.

If I had to assess the way the battle is coming out on the floor, I would guess that there are more parts of the budget being exempted from review than are being put under review. Just the economics of it will overwhelm us. The highway trust fund, for example, is an income elastic so it gets to be a bigger part of the total budget. The social security package is automatic. You are building more and more automatic expenditure devices into the budget, and therefore you are reviewing less and less of the budget, and I would like to have all that brought together in one place, so you can look at what you are doing in the aggregate, and the tax expenditure part of this is important.

Chairman PROXMIRE. I have some other questions which I will put in the record if you will answer them for the record. They are just a few.

Mr. ZWICK. Fine.

Chairman PROXMIRE. I very much appreciate it.

Mr. Conable?

Representative CONABLE. Of course, I think it is a very serious question whether we are adequately reviewing even that which we are trying to review.

Mr. ZWICK. I agree.

Representative CONABLE. Congressional oversight is a rather exaggerated term I am afraid, in the present practice.

Chairman PROXMIRE. It depends on how you look at oversight.

Representative CONABLE. This whole area of your testimony is a very beguiling one to a legislator of course, in the present condition of things, and I think you have made some real contributions this morning.

I just have one last question.

You put quite an emphasis on the need for more analysis in distributional considerations?

Mr. ZWICK. Yes.

Representative CONABLE. And I just wonder if this is not one area where we can trust Congress to be quite vigilant. We all are quite constituency-related, and we like to pride ourselves and even to base our survival on our knowledge of our constituency. For that reason do we really need as much analysis in this area do you think, as we do on the place these programs hold in the Nation as a whole, and with respect to the national interests as a whole?

Mr. ZWICK. Well, let me answer this and say you need analysis to show you alternative ways of accomplishing what you are trying to accomplish.

Representative CONABLE. Yes.

Mr. ZWICK. There is one incident I had as an Assistance Director to make this point. It led to all sorts of strange letters. But talking again about the lumbering activities of the Forest Service, it was possible from one table that they gave us in a program memorandum, to determine that we could improve the income to the Government by reallocating lumbering activities out of the Rocky Mountains into the northwest and southeast parts of the United States.

We raised this question, and after some turmoil and concern, they came back and said, "Aha, you people do not understand the true objective. This is an income subsidy to the Rocky Mountains. They get a percentage of the revenues from the Forest Service. If we put out those lumbering activities we will in fact take away income from specific areas and regions."

With that response we regrouped and thought about this for a while and said, Well, there is another part of the Department of Agriculture that is doing essentially regional analysis, and if you take a public policy objective subsidizing the income of that region, then perhaps there is an alternative way of doing it that is more efficient than lumbering.

For example, it may turn out that you want to have recreational facilities, skiing resorts as an alternative, and it would be a better use of our money to let the lumbering go where it is most profitable and use other programs to subsidize the region.

I made this statement somewhere and after that I was inundated with letters asking me where do they get money to open up ski resorts and so forth, and I never really did get out from under that one. But again somehow or other, in many of the analyses, distributional things have been treated as illegitimate things. They are legitimate. That is what you worry about very much. By making them explicit at least you might be able to accomplish the same objectives in a more effective way.

Representative CONABLE. I understand your points on that. Thank you, sir.

That is all I have.

Chairman PROXMIRE. Thank you very much, Dr. Zwick, for a fine job and most responsive testimony.

Mr. ZWICK. Thank you.

Chairman PROXMIRE. Our next witness is Mr. Lee White.

We are very pleased and happy to have Mr. White here this morning.

Mr. White holds degrees in both law and electrical engineering from the University of Nebraska. Following graduation from law school, Mr. White joined the Tennessee Valley Authority as an attorney in the Division of Law. From 1954 to 1957, he served on the staff of then Senator John F. Kennedy as a legislative assistant.

Following that, he was both counsel to the Senate Small Business Committee and, until 1961, administrative assistant to Senator John Sherman Cooper of Kentucky.

Since 1961, he has been assistant special counsel to President John F. Kennedy and special counsel to President Johnson. In 1966, he was appointed Chairman of the Federal Power Commission.

He became a partner in the law firm of Semer, White, and Jacobsen in August of 1969.

We are very honored to have you here, Mr. White. You are well known as an extremely competent Chairman in an area that is enormously important, and unfortunately I feel is kind of neglected.

STATEMENT OF LEE C. WHITE, A PARTNER IN THE LAW FIRM OF SEMER, WHITE & JACOBSEN

Mr. WHITE. Obviously I am very pleased and flattered, Mr. Chairman, to be asked to participate in this continuing series of inquiries that the subcommittee is undertaking. I think they are extremely useful, and I will at your pleasure either read the entire statement, which for the first time in three and a half years was written entirely by me, or hit the high spots. I do not have the staff now to prepare testimony, so it is all mine. I think I know it well enough that I can hit the high spots in a general sense, and then of course leave myself open to any questions.

Chairman PROXMIRE. Without objection the full prepared statement will be printed in the report, and you may proceed in your own way.

Mr. WHITE. Thank you, sir.

As Mr. Zwick's negative statement or testimony indicated, I do not think that necessarily these economic analytical tools are too appropriate to the regulatory bodies, because he managed to be here about an hour and never once mentioned the regulatory world, and I think frankly that this is probably the way it should be for the simple fact is that basically regulatory agencies do not face major problems of how to spend billions, or hundreds of millions of dollars.

I think it is appropriate for the Congress to focus on the budget of the Defense Department, Health, Education, and Welfare and all of the other budgets, where there is a tremendous amount of money.

As Congressman Conable suggested, there is a limit to the amount of time available to the Congress, and it could I think, profitably focus on those areas where there are large, large dollar amounts involved.

So to that extent, these analytical techniques have less relevance to the role of the regulatory agency.

However, I must hasten to add that I think they can be extremely useful to the agencies in discharging the congressional responsibilities that have been given to them. Primarily, they are agencies that are created to implement the constitutional assignment to the Congress to regulate commerce, and in fact most of them, including, for example, the Federal Power Commission, with which I am most familiar, came about when the Congress recognized that it simply was not a very efficient mechanism to make decisions as to who should construct hydroelectric projects on the rivers of this country. And so it passed a law and said that it would set up a commission to do that.

That Commission has now undergone a revision. It is now a five-man independent agency, rather than the original three-man agency, made up of the Secretaries of Interior, Army, and Agriculture. But I think

it is important to bear in mind that what those agencies are doing is the Congress' work. They are basically arms of the Congress, although of course they occupy some relationship and some appropriate and legitimate relationship with the executive branch.

One of the important points that I should like to make—and I hope you will forgive the elemental character of it, but I think it is important enough to stress continuously—is that without regard to the organizational structure, and without regard to the techniques for coming to better decisions that can be made, the improvements and refinements that can be developed, I think we come down to the basic proposition that what matters is who is making the decision, particularly in the regulatory agencies.

I do not mean to suggest that it is not appropriate to focus on techniques and methods. As I said at the outset, these are useful hearings, and in my prepared statement I have urged that the Joint Committee press some of the regulatory agencies to focus on the various techniques that have been discussed here and in the compendium that was compiled by the Joint Committee staff.¹

A regulatory agency does not, in a general sense, have the protection of a superior standing on top of it to see to it that the agency has reached the right decision in terms of the allocation of the Nation's resources or indeed in whether it is properly acting on the basis of the mandate given to it by the Congress.

In the executive branch, everything kind of piles up and it is the President's responsibility, and the President or his own staff can take hold of a Secretary or a Department or agency head who is not performing properly. He has a very difficult job doing that with the independent agencies, and in fact should he undertake to do so will immediately find himself embroiled in great political difficulty.

So that, in essence, those gentlemen who serve on regulatory bodies are answerable almost only to their own conscience. Of course, their decisions are reviewable by the courts, but the courts are most hesitant to substitute their judgment on specific technical issues for that of the agency. They will in the case of the law, but I cannot really overstate the importance of the selection process.

One of the unfortunate characteristics of regulatory agencies is the fact that in many ways they are reactors to somebody else's initiative. The CAB, for example, will find itself acting on applications for rate increases, not because that is part of their own plan or design or that they think it is useful, but because the airlines have filed applications for increases. How much of their resources and their staff will be devoted to a subject therefore may have nothing to do with their own belief as to how they can best use their resources.

The Federal Power Commission has before it today probably dozens of applications for rate increases, and its resources are going to have to be shifted to that point, because it must respond. An agency head will make every effort to allocate his staff and money in the most effective fashion, and in this respect he is somewhat blessed, because the Congress does appropriate money to them in a lump sum. Now the

¹ "The Analysis and Evaluation of Public Expenditures: The PPB System," a compendium of papers submitted to the Subcommittee on Economy in Government of the Joint Economic Committee (committee print), 1969.

money is not large. It is in the range of \$15 to \$20 million annually for each of the major Federal regulatory agencies, not a great deal.

Employees are on the order of 1,000 to maybe 1,500 or 2,000 at most. And it is helpful that they do have the right to use their money where they think it can best be put.

One of the areas that I think ought to be stressed is that of analysis of the industry's problems, the industry's future or, if you will, some long-range planning and thinking. I have brought with me what I regard as a superb illustration of that. This is the National Power Survey which was undertaken by the Power Commission in 1962.

It had the cooperation of all segments of the electric utility industry, and as you know, there is a great deal of rivalry and tension that exists between the segments that differ on the basis of forms of ownership. But all of them were willing to get together and work, and for this I think my predecessor, Joe Swidler, who was Chairman of the Commission, deserves great credit in having brought them together, and having got them to focus on their common problems, rather than those that divide them.

Nobody believed that every part of this report was perfect, but there was general agreement that the concept of a regulatory agency playing a leadership role in getting the industry to sit down to face some of the problems that obviously would come to it in the future, and to consider some of the means of meeting them was something that was proper and legitimate for the regulatory agency to do.

I think it is something that could be brought to the attention of all other regulatory agencies by this committee, to determine whether or not there are analogies in their own activities, so that they can see whether this is suitable for their undertaking.

Right now the Power Commission is in the process of updating this report which was issued in 1964, and it is now in the process of being updated and the new revision should be available by the middle of next year.

Quite interestingly, one of my major disappointments during my time at the Commission was my inability to persuade the appropriations subcommittees of the desirability of having a corresponding study or a roughly corresponding study in the natural gas area.

I think it could have been extremely useful, particularly today where there are suggestions and allegations and charges that there is a shortage of natural gas. In short, there are some undertakings that can be better done on a survey or an industrywide basis, rather than on an adversary case by case basis, and I would strongly recommend that this committee bring this forcibly to the attention of the other regulatory agencies.

Of course, in the regulatory agencies that have rate setting responsibilities, and those that issue licenses and certificates, there are the classical cases of economic argumentation. Indeed, the Federal Power Commission was told by two very distinguished courts, the Second Circuit Court of Appeals at the Court of Appeals level, and the U.S. Supreme Court, that its role in awarding hydroelectric licenses was not merely that of an impartial arbiter or referee among competing commercial interests, but its responsibility was to carry out the mandate of the Congress, which says that licensed projects must be consistent

with the comprehensive development of a waterway, and that it was its responsibility to determine what the whole range of reasonable alternatives were, and to determine whether something different from that that had been submitted by the parties ought to be considered.

Nobody can quarrel with the concept, but it does impose a strain on the resources of the agency. This then brings us to those sordid aspects of life, how to pay for these things that we agree are useful. It takes money, and understandably the Congress has a reluctance to allow these regulatory agencies to grow too rapidly, and I cannot quarrel. I think had I been a member of the appropriations subcommittee, I, too, would have looked pretty hard at the budgets that were submitted by regulatory agencies, including the one that I served on, but we cannot have it both ways.

If we are not willing to pay for it, we are simply not going to have the resources to do the type of analysis that I think would be useful, particularly when we are dealing with the allocation of resources in some very important fields, the energy field, transportation field, the communications field.

The next point that I would like to touch on deals with the manner in which the commissions have the interest of the public brought to their attention. It is, of course, their responsibility to reach decisions that are in the public interest. Sometimes, however, knowing what is in the public interest, other than simply the statement of the platitudinous objective, can be most difficult to determine.

I believe that Senator Metcalf's bill to create a Consumers' Counsel (S. 607) is a proper step in that direction. I think as a regulator, even though I know it is my responsibility to find the public interest, I can do a better job if the adversary process is at work, and there is somebody arguing before the body who is an advocate of the interest of the consumer. Whether that will be a bill that will be acted upon this year or next year by the Congress, I cannot say. I certainly hope so.

Similarly I have supported a proposal known as the People's Counsel, which is somewhat different from the Consumers' Counsel, in that it is broader, and would insure that those people who are in rulemaking positions will have before them the views of the economically disadvantaged, where those programs and the rules that they are promulgating have an impact on them.

An illustration is the food stamp program, which according to recent newspaper accounts may be in the process of being transferred from one great Department to another great Department, but unfortunately I believe that in the past, when rules have been promulgated governing the manner in which the stamp program will be operated, there was no mechanism for determining the view of the poor people, those who are the recipients.

We could be assured that the people who produced the food and processed it and distributed it were going to be heard, but I think it is equally important that somebody who is about to make a rule that will have an impact on people who are the beneficiaries hear from them.

Again I do not know where that proposal will go, but conceptually I think it makes all the sense in the world, and this sort of goes I think to the discussion you gentlemen had with Mr. Zwick about how can the decisionmaking process be improved.

One of the ways is to insure that whoever makes the decision has all of the views and all of the alternatives before him or them.

There are numerous other points that I might dwell on, but I think perhaps it would be more fruitful if I pause now and permitted you to ask any questions you may have.

(Mr. White's prepared statement follows:)

PREPARED STATEMENT OF LEE C. WHITE

Mr. Chairman and Members of the subcommittee, quite obviously the goals of this inquiry by the subcommittee, namely, greater efficiency in public expenditures and more effective rule-making through the use of economic analysis, are unassailable. Personally, I would rather be on record in opposition to apple pie or even reducing traffic congestion in our cities than to be against increased efficiency in Government. I believe discussion of some of the analytical tools that have been developed and refined in recent years can be helpful to both an understanding of the process and to some improvement of it. But, being realistic, one can predict that miraculous or revolutionary changes are not very likely.

As a recent refugee from a policymaking, or at least a decisionmaking position in the Federal Government—three and a half years as Chairman of the Federal Power Commission—I have reflected on my governmental experiences and have come upon a fundamental truth that mankind has been discovering and rediscovering for generations: Improvement and refinement of organizational structure and the development of analytical tools for rational thinking can be constructive forces, but the factor that really determines how effective a process will be is who is doing it. If the Government is to meet the challenges—and in every point in time those challenges are “critical,” “the most important in the Nation's history,” etc.—it must attract to policymaking positions those who are our best equipped by native intelligence, instinct, industriousness, experience and personal characteristics. It would be helpful also to pick those who have a habit of being lucky. The importance of the ability and the qualifications of the individual is especially pertinent in the case of regulatory agencies where, unlike the pyramid-type structure that exists in the Executive Branch of the Government, each member has his own vote, and, in a general sense, is answerable only to his own conscience. By stating this, I do not mean to suggest that this is not the way it should be—I intend only to emphasize the importance of the selection of individuals to serve on regulatory agencies.

I have assumed the subcommittee is most interested in any suggestions or observations I may have regarding the applicability to the missions of Federal regulatory agencies of the analytical methods discussed by the panel of distinguished citizens who have contributed papers to the compendium published by the Joint Economic Committee.

For the most part, regulatory agencies are not faced with the difficult problems of how to spend billions or millions of Federal tax dollars by evaluating which of several alternatives will be most efficient in accomplishing the objectives of a particular grant-in-aid program or a construction program. Basically, regulatory agencies are not engaged in operating programs and have relatively small staffs and budgets. Currently, the annual budgets of the major Federal regulatory agencies are in the 15–20 million dollar range. Despite these comparatively small budgets, or perhaps because of them, the agencies obviously must make every effort to get the very most out of their expenditures. The agencies have been fortunate in that their budgets are “lump sum,” with considerable latitude given the agency to assess its priorities and put the money where it is most needed or where it can do the best job—occasionally those two coincide. In many regards, regulatory agencies are organizations with limited initiative or choice as to how their funds will be spent. For example, the Civil Aeronautics Board may well need many more staff people to process rate increase applications than appeared at budget-making time. This will be not a question of the CAB's plans or desires, but will result from industry decisions. In short, the agencies are primarily reactors, not initiators.

I strongly believe the interest of the public will be better served if the agencies can use more of their resources for planning, analysis of the industries they regulate and for providing some leadership, either by prodding or by showing the

way. The illustration that comes quickly to mind is the National Power Survey undertaken by the FPC in 1962 with the participation and cooperation of each segment of the electric utility industry. Under the effective leadership of my predecessor, Joseph C. Swidler, a comprehensive assessment of the industry was undertaken, together with projections for the future and some rather specific recommendations. Not all who participated agreed with each conclusion or recommendation, but there was general accord that the exercise had been useful for all and, most significantly in my view, that it was a proper, affirmative undertaking for a regulatory agency. Incidentally, the FPC, again with industry-wide participation, is in the process of updating the survey which is scheduled for completion during the middle of next year.

Although the idea for the survey was hatched before I got to the FPC, it occurs to me that no list of suggested approaches to regulation would have given the guidance or skills required for such an undertaking. I would hope and urge, however, that the Joint Economic Committee would encourage regulatory agencies to examine the Power Survey to determine whether any or all of the various areas explored in that study would be suitable for comparable undertakings in connection with industries they regulate. Moreover, assuming that the Joint Committee shares this view of the usefulness of such undertakings by regulatory agencies, I earnestly urge that those views be made known to the key subcommittees of the Appropriations Committees of the House and the Senate. One of the major disappointments of my tenure at the FPC was my inability to persuade the Appropriations Committee of the worthwhileness of a national natural gas survey.

Applying the basic test of the best return for the expenditure of agency dollars, I am convinced that reasonable sums devoted to such broad, nonadversary inquiries produce far more meaningful results than the dollars devoted to the more traditional case-by-case approach. Similarly, I would urge the strengthening of the staffs and the participation by economists in all phases of the regulatory process. I would hope, too, that many more economists, who thrive in academic climes, would be willing to undertake positions in regulatory staffs where their economic theories and analyses could be translated into regulatory principles and concepts. Increased emphasis on economic analysis in the regulatory process, which I strongly support, does not mean that there should be a transfer of focus to approach at the expense of results. Tools are to be used to achieve the best answers, not as substitutes.

The areas of greatest applicability of economic analysis to the work of regulatory agencies today obviously lie in the economic functions assigned to the agencies: rate setting, certificating or licensing, evaluating mergers, regulating service. In these activities, the classic forms of economic argumentation and casebuilding are practiced. What needs to be done, in my view, is to insure that the decision-makers have available the most effective advocacy for all points of view. Thus, I have supported S. 607, Senator Metcalf's bill which would provide for a Consumers' Counsel who would be paid by tax funds to present the case of the consumers in all proceedings before regulatory agencies. The current experiment by the Federal Communications Commission in its discussions with American Telephone and Telegraph Co. in designating two FCC staff lawyers to ask questions and to assume the "bias" of the consumer moves in this direction. An argument against the Consumers' Counsel idea frequently made is that the Commission itself is obliged by law to find the public interest. Certainly that is true, but I believe one can do a better job of determining what the public interest is if there are effective advocates for all economic and other parties in interest.

Further, I have supported the idea of creating a People's Counsel which would be authorized to appear before the Government departments and agencies which adopt rules of general applicability to represent the views of those elements of our society which cannot afford the effective representation that major corporations and industries are able to obtain. In short, the proposal would provide a Covington & Burling for the economically disadvantaged. An example may be helpful. If the Department of Agriculture is contemplating a change in the manner in which food stamp programs distribute stamps or food, the views of those most heavily affected should be sought. One can assume that the views of food producers, processors, transporters, and distributors will be effectively presented. But so should the needs, suggestions and advice of the recipients.

The courts in two very significant cases, *Scenic Hudson Preservation Conference v. FPC* (354 F. 2d 608, CA 2-1965) and *Udall v. F.P.C.* (387 428, 1968)

have made it crystal clear to the FPC that its responsibility in granting licenses for the construction of hydroelectric projects is not merely to serve as referees among competing commercial interests, but rather it is to consider a range of reasonable alternatives to the particular applications submitted to it. The statutory mandate to the FPC is to license only those projects which in its judgment ". . . will be best adapted to a comprehensive plan for improving or developing a waterway or waterways." The FPC, through participation by other parties or by its staff must, said the courts, consider all reasonable alternatives to the proposed project or projects. This can be a very burdensome assignment in terms of staff resources and in terms of the time required for processing applications. But there can be no quarrel with the concept. Once again, however, this requires more staff and consequently greater appropriations.

Another facet to this problem of resources allocation requires comment. Under existing law, the FPC cannot directly require a license applicant to do anything. It can grant a license to an applicant to construct and operate a hydroelectric plant, and it can impose conditions it believes are necessary and appropriate to secure the comprehensive development of a waterway. But the Commission cannot require the applicant to accept it. If the FPC believes a conventional fossil-burning steam plant for generating electricity at a particular location will best serve the public interest, the applicant can say "Thank you for your guidance" and then proceed to construct whatever type of project (other than hydro) it chooses and locate it where it wishes, insofar as Federal law is concerned. (It does require a license from the AEC for a nuclear plant related to the safety aspects of it.) Thus, in the case of some regulatory agencies, it may be desirable to determine whether additional statutory authority is required if the agency is to make a real contribution to the process by which economic and physical resources are to be allocated. Note for example, last week's decision by the ICC that it does not have the authority to inquire into the quality of railroad passenger service.

There is, I believe, a special obligation on the part of the regulatory agencies to harmonize their activities and decisions with basic national policies not necessarily found in the statutes which they administer. For example, those agencies with rate-setting responsibilities should consider the financial needs of the utilities in acting on applications for rate increases, but they should also consider the inflationary effects of any proposed increases and the obvious desire of the Nation to control inflationary pressures. In the transportation field, the CAB should, for example, consider the effects of its decisions on the railroad, bus, shipping and private automobile modes of transportation. A recent court decision also requires the CAB to consider noise and air pollution and safety for people on the ground. Similarly, it should hear from those sectors in its decision-making process. The Department of Transportation was given the responsibility and authority to express national transportation considerations before the various regulatory bodies. How effectively the Department has discharged this duty should be looked at by this or other appropriate committees of the Congress. In another area, the Department of Health, Education and Welfare has been quite vigorous in intervening in those FPC cases involving air pollution issues to urge its particular point of view.

One of the trickier areas facing regulators is to distinguish between implementing national policy and establishing it. Again, to use an illustration most familiar to me, the FPC must authorize the necessary facilities if natural gas is to be imported into the United States from Canada. But to what extent this should be done obviously rests on this country's and Canada's basic understanding and policies on resource exchanges. Thus far, those national decisions have not been reached—although happily President Nixon and Prime Minister Trudeau have directed the appropriate departments of Government on both sides of the border to explore these issues. In the meantime, the FPC, hardly the Nation's most skilled and appropriate agency for formulating international policy, must act on the applications submitted to it by proper parties. Yet its decisions in specific cases can, in the absence of any national policy, establish a policy. Here I believe there is an obligation on the regulatory bodies and similarly on the Congressional Committees which exercise oversight responsibilities over them, to flush out these major issues and urge appropriate action by the Executive and Legislative Branches of the Government. In the illustration of Canadian natural gas, the FPC can and should be of assistance in formulating recommendations for basic national policy in this important area of resource management.

From where I sit, an excellent example of agency initiative was the movement of both the Federal Trade Commission and the Federal Communications Commission into the field of cigarette advertising. The problem was anything but simple and straightforward, and yet the agencies did assist in focusing Congressional and national attention on a basic policy issue.

Reasonable men can—and do—differ as to whether the statute their agency administers provides authority to handle certain problems. Again, refer to the ICC decision on the quality of rail passenger service, where the Commission split on the issue 7-2. My general attitude during my service at the FPC was to assume the broadest possible mandate—to believe that the Congress intended that certain basic objectives were to be achieved. Certainly one cannot rewrite the law, but the tendency to overjudicialize must be constantly guarded against. The agencies frequently find themselves caught in the classic dilemma: on the one hand, all parties must be given full due process and their day or so in court, and, on the other, is the desire to reach a decision before the passage of time has rendered the entire matter moot. This vexatious problem has defied legislators and regulators for decades.

One particular approach that may be worthy of examination by regulatory agencies is the technique of required public comment by the regulatory body. For example, when the FPC proposed legislation in the 90th Congress which would vest in the FPC the authority and the obligation to promulgate rules of operation related to the reliability of the power supply in the United States, the electric utility industry protested that such action would shift authority to the Government, while leaving responsibility with the utilities; further, it was claimed that nothing but delay would flow from such an arrangement. Without conceding the validity of those criticisms, it occurs to me that an alternative worthy of being tried out is to require the industry to advise the Government of the standards which the Nation's utilities voluntarily adhere to, but require the FPC to comment publicly on those standards. Presumably, the prestige and the technical competence of the Commission and its staff would have a healthy and beneficial influence on the industry in developing the standards that would be employed by the industry. But, if the advice, counsel, guidance, or criticism of the FPC—and I would include an opportunity for State regulatory commissions to comment as well—did not result in effective standards or criteria, the obligation on the part of the Government to disapprove in total or in part would, I think, exert useful pressure on the utilities to defend publicly the decisions it reached.

This technique, in my view, represents at least an acceptable fall-back position to be considered by the Congress in those areas where, for whatever reason, it is regarded as undesirable to grant affirmative authority to regulatory bodies. Basically, I am not enthusiastic about the approach, but it may be considered in some very special circumstances.

Although the role of the regulatory agencies is to discover and protect the public interest, it is evident that insofar as licenses or certificates are concerned, they are items of considerable value to the licensees. It is no secret that simply having the right to build and operate a television station in a major metropolitan area is a right worth millions of dollars. Similarly, airline routes which are so vigorously sought by numerous applicants to serve major markets have great intrinsic value. The FPC frequently has competing applications to serve identical markets by more than one pipeline, because of the great profit-making potential that those certificates represent. In such a situation, it seems evident that the cost of administering the program should be borne by those who seek to obtain those rights. The concept is, I think, now well established and in referring to the FPC, the agency that I know most about, nearly half its \$16 million annual budget is recovered in user charges.

These funds are paid into the general Treasury and are not available for use by the agency, although any simple accounting process makes it clear that the agency is at least in part self-sustaining. Countless suggestions for increasing the amount paid for these rights have been made in the past. I am not prepared to support any particular approach (for example, the suggestion that radio and television licenses should be auctioned off to the highest bidder), but I certainly believe that enough studies, surveys and reviews have been made and that it is now time for the Bureau of the Budget to propose changes and for the Congress to act.

CONCLUSION

In summary, the analytical techniques that have been developed by the Defense Department and the Bureau of the Budget can be of some use to regulatory agencies. I would again emphasize, however, the overriding importance of the need to select qualified personnel to serve on those bodies. The responsibilities inherent in those positions are enormous, and, in fact, one of the basic difficulties in holding such a position is the absence of any set of standards by which to judge the level of performance. I believe that the interest of the Joint Economic Committee and of other Congressional Committees in the work of regulatory agencies can be a positive influence and urge that the Congressional Oversight role be strengthened.

The tendency of regulatory agencies to react to the initiative of industry requires both a conscientious effort on the part of the agencies to break away from the case-by-case approach and adequate financial support from the Congress. Although the pattern is not distinct and universal, there does seem to be a cycle through which Federal regulatory agencies pass. I believe that their usefulness can be increased and their contribution to national problems, including exerting significant influence on the manner in which our economic resources are applied, can be made even more significant and responsive to the Nation's needs.

I appreciate the opportunity to present my views to the Subcommittee and hope that this series of hearings will move Government officials to greater recognition of the benefits of economic analysis to the basic missions assigned to their departments and agencies.

Chairman PROXMIRE. Mr. White, some critics have said that the Federal Power Commission and the other regulatory agencies have not really utilized economic analysis at all satisfactorily, that there are all kinds of areas where they could use it and do a much better job. With regard to considering alternatives, when licensing, providing a decision in licensing, here people say there should be a full economic analysis.

No. 2, the application of economic analysis in principle, in allocating radio, that is not FPC, that would be FCC, but nevertheless it is a regulatory determination.

No. 3, the role of economic analysis in rate regulation.

Of course, this would be a Federal Power Commission determination.

Mr. WHITE. Yes.

Chairman PROXMIRE. In your view, on the basis of your experience, do you feel that these criticisms are justified, that there is a very useful area of economic analysis that is being overlooked?

Mr. WHITE. I would say that generally I can subscribe to the criticism, but I would have to temper it. The manner in which it came through to me made it sound like it is almost zero, and that is not accurate. There is quite a bit being done, and there is a movement upward, which frankly is the only way we can go. We cannot go very far down, because we are at such a low level.

Let me tick off an illustration or two. The Federal Power Commission has one of the most vexatious assignments ever given to any body, and this is to set the price at which natural gas can be sold by the producers as it moves into interstate commerce. It is just really a horrendous job.

The Commission has struggled over about an 8- or 9-year period. It has come up with the concept of establishing one rate for an area, an areawide rate that affects all producers, regardless of the size of the producers in that area. This has been found by the Supreme Court to be constitutional, to be not in conflict with any statute, and to be a reasonable manner in which to proceed.

In the conduct of those cases, considerable economic analysis has been brought to bear on the decisionmaking process. Each element of the cost of production is gone into with adversary advocates on either side saying yes, that is too much, and others saying no that is not enough.

The Commission itself sponsored an econometric model. The econometric model was certainly not perfect, and indeed when it got right down to it, the Commission did not use the findings of the econometric model, but recognized the commonsense of having such an analysis available to it in its decisionmaking process.

We had one fascinating experience. An econometrician retained by the FPC as a consultant spoke to the members of the Commission informally. He had a big blackboard, a piece of chalk, and he had diagrams that went on and on and on and he explained that each of these were legitimate measurable factors that could be put together and weighed. I could sense that the members of the Commission were recognizing that what he was saying was that if he had this model, and you agreed to it, that all you had to do was crank in these figures, turn the handle, and the answer would come out and five fellows would be out of a job.

Well, they were not at all sympathetic to that notion, and since most agencies are made up of lawyers, it was a Donnybrook right off the bat.

I think that the economists and the econometricians can make a much greater contribution. In my prepared statement I take note of that.

Chairman PROXMIRE. I think this is very helpful, but you are being facetious, aren't you, completely? The econometric model would be only a guide. Of course it is like any other mechanical device of this kind. It all depends on your assumptions. It all depends on what you crank into it. It all depends upon the expertness and the appropriateness of the analysis before you put it in.

Mr. WHITE. Right. I was being facetious.

Chairman PROXMIRE. This involves very competent people. It seems to me our experience in Government since the dawn of the computer, and with all the work that that has done has indicated that it does not exactly reduce the Federal employment to zero.

Mr. WHITE. I was being facetious, but it was interesting to see the reaction of the members of the Commission who were, all but one, lawyers.

Representative CONABLE. Don't put this all off on the lawyers.

Chairman PROXMIRE. I think it is a good place to put it.

Representative CONABLE. Any two economists are going to fall to arguing about their econometric models immediately.

Mr. WHITE. Yes, I agree, but I think that the chairman's point is that you are much better off to have had that exercise done than not to have had it done. You may not come out with a better result.

Representative CONABLE. Yes.

Mr. WHITE. But if you do have it, it makes an input. It does help shape your thought process. I started off saying you are not going to get any better decisions than you have people there. All we are talking about here are tools and techniques.

Chairman PROXMIRE. I take it this is not a typical example. You are giving us one instance in which economic analysis was used?

Mr. WHITE. That is right.

Chairman PROXMIRE. Can you give us a couple of areas in which you think economic analysis should be used that has not been and would be useful if it were?

Mr. WHITE. I am not as familiar with the other regulatory agencies as I am with the Federal Power Commission, but I have a belief, for example, that in the field of transportation, that economic analysis by both the Interstate Commerce Commission and the Civil Aeronautics Board could be considerably improved in terms of the impact of their decisions that relate to air on the other modes of transportation. In fact, when the Department of Transportation was being considered, those who recommended its creation believed that this is one of the important functions that it could perform; namely, testifying and presenting national policy considerations to these regulatory agencies as they reach their decision. This raises another major item, and that is, how in the world do five men, or a majority of any commission, figure out how their responsibility to decide a specific case fits with national requirements and patterns and policies.

I use in my statement an illustration that has to do with the importation of natural gas from Canada. When an applicant comes to the Commission and says it would like to have authority to build facilities to import gas, the Commission cannot reject that out of hand. It has to decide whether it should be granted, and one of the important ingredients in such a decision is what does the United States think as a national policy it ought to do about the movement of energy sources back and forth across the border.

If it reaches any kind of a decision, even if the decision is to deny it, or to approve it with certain conditions, that then becomes a part of a pattern that ultimately will be a national policy, and I daresay that the Federal Power Commission is probably not the appropriate mechanism to be dealing with those policy issues.

Chairman PROXMIRE. Under these circumstances, are you implying that more adequate economic analysis would be useful and helpful?

Mr. WHITE. That is the easiest question I will have all day. Yes; no question about it.

Chairman PROXMIRE. Let me put it this way. In your opinion is the present lack of analysis and of planning primarily a problem of inadequate resources, or is there a reluctance on the part of the policymakers to exercise this kind of responsibility?

For example, if there is such a reluctance, how much of it is due to pressure brought upon the agencies by industry? Are they afraid that if you did this in a logical way, in which you got a great deal of economic analysis, so that it could be decided more on the merits, the industry pressures would not be as effective?

Mr. WHITE. I understand fully the import of the question, and I do not think I can give you a yes or a no answer to it.

In part I am satisfied, in fact in major part, it is because of the lack of adequate resources. I think generally anybody who is in a decision-making position would love to have more economic analysis and data available to him to assist him, and furthermore to support the—

Chairman PROXMIRE. Then why don't they do it?

Mr. WHITE. In part, it is because of the unwillingness of Congress to let them grow in staffs, but there are other techniques.

Chairman PROXMIRE. Have they been turned down? Has the Budget Bureau said no? Has the Federal Power Commission applied for a larger staff and been refused by the committees of Congress?

Mr. WHITE. Yes, I am sorry to say that has been the case, and what I do not know is whether it is just the—

Chairman PROXMIRE. I mean in this particular area of economic analysis?

Mr. WHITE. Well, since our budgets are a lump sum, but with pieces, with elements all laid out in our budget presentation, yes. The fact of the matter is we had a situation in which one of the analytical techniques for electric reliability has to do with the gathering of information, not only technical but economic data, and a member of the Independent Agencies Appropriations Subcommittee of the House took the floor to say specifically that the FPC had requested 29 positions for this, and it had been denied by the committee, and they wanted to make clear to the agency, which operates on a lump-sum budget, that they were not to use any of the money available to them for that particular function. So the answer is "yes."

Chairman PROXMIRE. Was this done because of industry pressure?

Mr. WHITE. No. Now I am terribly embarrassed. It is because I was not able to persuade the committee of the importance of it or the subcommittee of the importance of it. I do not think in the "peanuts" that are involved there in that particular case, and in that particular agency, that it was industry pressure, but to go to the other—

Chairman PROXMIRE. How about the justification of your cost effectiveness?

Mr. WHITE. I think that is where we failed the test, yes, and it is hard to persuade the members of these committees, that these agencies should have more, even though the industries that are regulated continue to grow in complexity, in numbers, in dollars, in importance, in the companies and in the nature of the assignment.

The Federal Power Commission has fewer employees today than it had in 1964, not by choice, not because a group of hardheaded managers had been there and pared them down. You just cannot get the money out of the Congress.

Chairman PROXMIRE. My time is up.

Mr. Conable?

Representative CONABLE. Mr. White, in this whole issue of court review of regulatory agencies, you pointed out the reluctance of courts to intrude on administrative discretion, and I think that is generally true, unless there is an obvious abuse of discretion. Courts in reviewing the record in an administrative case are usually going to leave the decision alone.

The result is that court review is something that is used only in the extreme, when people feel there has been an obvious, patent abuse of discretion.

I wonder if court review is going to be of any significance at all, if regulatory agencies are attempting to fulfill what in your statement you call a special obligation to harmonize their activities and decisions with basic national policies, not necessarily found in the statute which they administer.

In other words, if the agency is going outside the record substantially, considering things other than what is presented to them in

evidence or in papers supporting applications, is it going to be possible to have court review to any degree? I just do not have this resolved in my own mind.

Mr. WHITE. I see the spot where you have your finger, and I think that the answer is yes, that the courts are capable of determining whether in discharging its responsibility under the particular statute that it administers, it has reached out and taken into account other factors. Let us perhaps use an illustration.

It does not say anything in the Natural Gas Act about the anti-trust laws, and yet the Federal Power Commission had a case reversed by the court of appeals, which said that in granting a certificate to one of two applicants, the Commission had failed to give appropriate attention to the antitrust considerations. Well, the FPC should. Obviously that is the national policy. There are a whole host of similar areas where there is national policy.

Representative CONABLE. But that is national policy embodied in law also, and the court can take judicial notice of any existing statute.

Mr. WHITE. Right.

Representative CONABLE. Even though it was not part of the administrative decision of the regulatory agency.

Mr. WHITE. Right. Take, for example, the question of discrimination in employment. The Federal Power Commission has before it a proceeding by a utility to have a license granted for a constructed hydroelectric project. A party has appealed, or rather sought to intervene, saying, do not give that outfit a license, because they discriminate in their employment policies.

The Commission said, "We will permit the parties to intervene."

I do not know how that case is going to come out, but the basic thrust of the petition to intervene was on the grounds that the particular utility engaged in discriminatory employment practices.

That, too, though, as you say or suggest is embodied in the statute.

Representative CONABLE. Let us take another situation. I am informed that President Johnson in May of 1967 wrote to the heads of the regulatory agencies asking them that agencies make every effort to aid our balance-of-payments objectives in any decision affecting the balance of payments of our country.

Now what weight could an agency give to this? This was a voluntary program, not embodied in any law. What weight could an agency give this? And is this something that a court should consider also?

I can see that you get into kind of a gray area here.

Mr. WHITE. It is a sticky area. It is pretty treacherous out there in those waters. I would say that if that is a national policy, there are ways to make sure that the weight to be accorded that can be brought to the attention of the decisionmakers, because every Department of the Federal Government or State government has the right to intervene formally in a proceeding.

It is not at all uncommon, for example, for the Department of Health, Education, and Welfare to come into a proceeding before the FPC, and say, "Gentlemen, we think you ought to grant this certificate for natural gas to go into the city of New York——"

Representative CONABLE. Yes.

Mr. WHITE (continuing). "Because they will use that gas to generate electricity with far fewer pollutants than if they were to use oil."

Representative CONABLE. Quite obviously, if it is not an expression of statute, you are going to be careful in the extent to which you give implementation to it in exercising your discretion?

Mr. WHITE. Absolutely.

Representative CONABLE. And not go as far as you might if it were simply a matter of statute.

Mr. WHITE. By definition—

Representative CONABLE. Let me ask you what was the effect of a letter like this from President Johnson on your agency?

Mr. WHITE. As you were reading that I was trying to remember first of all whether it had registered in my mind, and second of all what had been the effect, and since the Federal Power Commission has so little to do with international problems—

Representative CONABLE. It might have something to do with natural gas from Canada, for instance.

Mr. WHITE. There is an area where it would have something to do with natural gas from Canada, and if I recall correctly, when that application was filed by a pipeline to construct the facilities to bring the gas down, the producers, the domestic producers in this country, I believe, from Texas, appeared before the Commission in that proceeding, and said, "You should not grant that license because it will be harmful to the natural gas industry in the United States, because we need to have the money to use for exploration and development." And I believe they also said in their argumentation that this is contrary to the Nation's balance-of-payments policy that exists in this point in time.

Now the Commission granted the certificate, so even if I could remember, I guess it would be inappropriate to tell you how that was weighted, but it was certainly before the Commission in a formal sense raised by one of the parties.

Chairman PROXMIRE. Could you yield, please?

You said "granted." Do you mean that they approved the importation of natural gas from Canada?

Mr. WHITE. Yes.

Chairman PROXMIRE. They did. In other words, they denied the petition of the Texas people?

Mr. WHITE. That is correct. The Texas people intervened.

Representative CONABLE. That is all I have, Mr. Chairman, at this time.

Chairman PROXMIRE. I just have one other question, Mr. White. I am interested in your thoughts on user charges as a way to finance the cost of administering regulatory programs. Can you explain the operation of user charges in the Federal Power Commission by which, according to your testimony, nearly half of its annual budget is recovered, and list for us some of the other user charges that have been proposed?

Mr. WHITE. I would feel better equipped to answer that question if as in earlier congressional appearances I had a solid staff behind me. I can certainly undertake to supply that answer in detail, using the staff, and I am sure that the Commission would be perfectly willing to submit it, but in a general sense let me indicate the user charge situation.

Fees are charged for licenses to construct hydroelectric projects.

Fees are charged for certificates to construct interstate pipelines. The fee structure is established by the Commission, I think in consultation with the Budget Bureau, and are collected and turned into the General Treasury.

There is an additional source of revenue that comes into the General Treasury as a result of the Federal Power Commission action, and that has to do with the assessment of headwater benefits.

If, for example, in the topography of a river a Federal project enhances the power generating potential of a privately owned and licensed project, that licensee is obliged by law to pay for those benefits, and the Federal Power Commission has the responsibility to assess what is a fair charge for those benefits, and then to have the fees paid to the General Treasury. Those are the basic sources of the income.

As to how they might be altered, the schedule of fees themselves were made by man, and I assume they could be modified by man, either upward or downward. I have in my statement spoken about the suggestion that is most frequently heard in connection with television and radio certificates or licenses, and that is to auction them off. They are indeed valuable documents to have, and the concept of auctioning off a public right is nothing new.

Today in offshore Louisiana, in the Federal domain, the property that the Congress has decided belonged to the Federal domain, where oil and gas is discovered, the right to go out and explore that and to develop it is auctioned off.

Senator PROXMIRE. I can understand how you can do it with something as commercial as a right to produce oil, but I am just wondering whether this would be appropriate for something like a television license, or radio license, where you have considerations of which applicant can best serve the public interest, and is equipped to do it, and on the basis of their background and experience would more likely do it. Maybe that is the best way to do it.

Mr. WHITE. I would assume, if anyone ever got serious about that proposal, that you would have to have an auction among qualified applicants, not among just those who are qualified because they are wealthy. I presume—I have never had the responsibility sitting as a member of the Federal Communications Commission, but it is not inconceivable that for any particular license there may be 12 applicants, and they can determine that any one of six could do the job beautifully.

Chairman PROXMIRE. Yes, but once you do that, once you sell it, then it seems to me that the applicant who buys it has a property interest. He is in a much stronger position to say "This is no longer the public's. I paid for it. I paid good hard cash for it."

Under these circumstances, if after 3 years they have not done a good job, they have been very partisan, very unfair, they have not really served the public interest, it seems to me it is a little harder for the FCC to deny it than now.

We had an interesting appearance before the committee earlier this week by a distinguished expert in this area, and Mr. Conable and I—Nicholas Johnson was the man—we had a very interesting colloquy with him. It seems to me once you sell it, you no longer retain the same degree of control.

Mr. WHITE. Well, this is outside of my field, but there are those who suggest that even under the existing system, and particularly if

pending legislation is enacted, it is going to be that way anyhow. That is the license holder has such—

Chairman PROXMIRE. That is Johnson's position, and I disagree with him very much, but he may be right. I hope not.

Mr. WHITE. Well, I think what you are getting into is what motivates men when they are making these decisions, and perhaps you are right, that if a man has paid \$2 million for a valuable right, it will be much more difficult for a majority of the Commission to look objectively at how he has handled things, because they are going to hate to see that fellow lose that money. By the same token today, when you give him the right, he goes out and invests a lot of money, and that I understand is the rationale underlying the legislative proposal.

How can you so say to the sponsors of it, how can you expect a man to invest if you do not give him at least some degree of assurance that his investment is going to be protected. So this is really a part of the same piece of fabric, as I see it.

Chairman PROXMIRE. Let me just conclude by asking if you can indicate broadly or generally how Congress can begin to develop a comprehensive program of user or beneficiary charges tailored to the requirements of each agency. You have done a good job in the Federal Power Commission I think. You have moved along the path as you say of raising half your budget. Do you have any broad recommendations as to how other agencies can do this?

Mr. WHITE. Well, I heard the discussion earlier this morning about a commission or a study group, and I do not believe that this is an appropriate topic for yet another study and review group. I just think somebody in the Budget Bureau, working with the White House and the President, ought to make some specific recommendations to the Congress, and that congressional committees can take a look at it and make the decision.

I do not think it is all that difficult to do. It will not get any less difficult with yet another review or study, because I have a hunch that Mr. Zwick's successors will be glad to supply you with an awful lot of documents, and not claim executive privilege on that subject.

Chairman PROXMIRE. So you would suggest that when Mr. Mayo appear before us, which he will in a few days, we might ask him if he would undertake this kind of an investigation, and then make a recommendation to the President and the Congress?

Mr. WHITE. Having known Budget Directors in the past, and knowing Budget Director Mayo somewhat, I am sure he will be highly sympathetic to the question.

Chairman PROXMIRE. That should help all of us. Thank you very much, Mr. White. You have done another excellent job, and we very much appreciate it. We have a few questions for the record which we will appreciate it if you could answer in writing when you correct your remarks.

Mr. WHITE. All right, and on that specific question of user charges. I will be delighted if you think it would be useful to ask the Commission if they would make that available. I am sorry I do not have that.

Chairman PROXMIRE. Yes, I wish you would. Then you could fill out the details.

(Additional materials, subsequently supplied, follow :)

FEDERAL POWER COMMISSION,
OFFICE OF THE CHAIRMAN,
Washington, D.C., October 10, 1969.

Mr. RICHARD F. KAUFMAN,
Subcommittee on Economy in Government,
Joint Economic Committee,
New Senate Office Building, Washington, D.C.

DEAR MR. KAUFMAN: Former Chairman White has relayed to me your request for a detailed statement of user charges the Federal Power Commission has received in recent years, together with a summary of any proposals that may have been under consideration.

Enclosed is data on the source and application of funds collected by the Federal Power Commission for fiscal years 1967, 1968 and 1969. The latest action establishing additional fees was taken in January 1966, when natural gas pipeline certificate fees were prescribed. No proposals for other fees for services have been presented to the Commission for consideration since then. We are planning a general review of fees charged for services performed.

We trust that this information will be satisfactory.

Sincerely,

JOHN N. NASSIKAS, *Chairman.*

Enclosure.

FEDERAL POWER COMMISSION—SOURCE AND APPLICATION OF FUNDS COLLECTED FROM ALL SOURCES

	Fiscal year 1969	Fiscal year 1968	Fiscal year 1967
1. Source of funds:			
Annual fees from licensees:			
Collections for administering part I of the Federal Power Act.....	\$2,573,336	\$2,142,370	\$2,357,036
Collection for use of Federal lands.....	212,543	201,550	255,209
Collection for maintenance of navigation.....	443,005	437,595	619,355
Fines, penalties, and other forfeitures.....	1,945	30,526	936
Collection for use of Indian lands.....	241,736	241,722	241,756
Oregon and California land grant.....	1,172	1,172	1,172
Subtotal annual fees from licensees.....	\$3,473,737	\$3,054,935	\$3,475,464
Headwater benefit payments.....	2,561,041	1,694,881	1,934,780
Subtotal, collections under section 10(e) of the Federal Power Act.....	6,034,778	4,749,816	5,410,244
Sale of publications and miscellaneous services.....	13,154	13,140	12,807
Pipeline certificate fees.....	2,163,488	1,634,809	897,997
Subtotal other collections.....	2,176,642	1,647,949	910,804
Total collections.....	8,211,420	6,397,765	6,321,048
2. Application of funds:			
Credited to "Miscellaneous receipts"—U.S. Treasury:			
Collections for administering part I of the Federal Power Act.....	2,573,336	2,142,370	2,357,036
Portion of collection from projects on Federal lands.....	26,568	25,194	31,901
Portion of collection from maintenance of navigation.....	221,502	218,798	309,677
Sale of publications and miscellaneous services.....	13,154	13,140	12,807
Fines, penalties, and other forfeitures.....	1,945	30,526	936
Pipeline certificate fees.....	2,163,488	1,634,809	897,997
Subtotal "Miscellaneous receipts".....	4,999,993	4,064,837	3,610,354
Payment to various States (37½ percent of collections from projects on Federal lands).....	79,704	75,581	95,704
Payment to reclamation funds from headwater benefits and projects on the Federal lands.....	1,639,105	1,364,589	1,374,249
Special fund for Department of the Army—From headwater benefits and navigation maintenance.....	1,249,710	649,864	997,813
Oregon and California land-grant fund.....	1,172	1,172	1,172
Collection for use of Indian lands.....	241,736	241,722	241,756
Total payments.....	8,211,420	6,397,765	6,321,048

SEMER, WHITE & JACOBSEN,
Washington, D.C., September 30, 1969.

Mr. RICHARD KAUFMAN,
Joint Economic Committee,
G-133 NSOB,
Washington, D.C.

DEAR MR. KAUFMAN: Enclosed are the responses to the written questions that were presented to me at the hearing of the Subcommittee on Economy in Government on September 19. It has taken a little time to obtain the enclosures, but I hope that they will be worth the extra time required to prepare the answers.

Quite obviously, if you have any additional questions about these suggestions or, for that matter, about anything else, please let me know and I will do my best to respond.

Sincerely yours,

LEE C. WHITE.

Enclosures.

Question 1: I am intrigued by the notion of the Consumers' Counsel, as would be created by Senator Metcalf's bill, and your concept of the People's Counsel. I am not altogether clear, however, how the People's Counsel would differ from the Consumer's Counsel. Would you elaborate on this idea, explaining such matters as who would pay his salary, how he would be insulated from the same kind of pressures which now operate on government employees, and how he would decide which cases to get involved in?

Answer: In response to your question about the distinction between the Consumers' Counsel and the People's Counsel, there is a similarity in that each would undertake to represent a broad segment of the public before decision-makers in our society. The basic difference, however is that the Consumers' Counsel would represent a class of customers of utilities whose own economic interest is so small on an individual basis and so diverse as to make it impossible for them to band together to secure the type of legal counsel (including economic analysis) required for rate cases before Federal and State regulatory agencies. The People's Counsel, on the other hand, would undertake to represent those individuals in our society who are economically disadvantaged in general rulemaking proceedings before Government agencies contemplating rules having an impact on those economically disadvantaged. As a matter of interest, I am enclosing (a) a copy of S. 607, which reduces the Consumers' Counsel idea to legislative form and (b) a resolution adopted by the Administrative Conference of the United States in its December 1968 plenary session proposing the People's Counsel concept. I will, of course, be pleased to discuss either or both of these proposals in further detail if that is desired.

(Enclosures follow:)

91ST CONGRESS
1ST SESSION

S. 607

IN THE SENATE OF THE UNITED STATES

JANUARY 24 (legislative day, JANUARY 10), 1969

Mr. METCALF (for himself, Mr. AIKEN, Mr. DODD, Mr. HART, Mr. KENNEDY, Mr. MCGOVERN, Mr. MANSFIELD, Mr. NELSON, Mr. TYDINGS, Mr. YARBOROUGH, and Mr. YOUNG of Ohio) introduced the following bill; which was read twice and referred to the Committee on Government Operations

A BILL

To establish an independent agency to be known as the United States Office of Utility Consumers' Counsel to represent the interests of the Federal Government and the consumers of the Nation before Federal and State regulatory agencies with respect to matters pertaining to certain electric, gas, telephone, and telegraph utilities; to amend section 201 of the Federal Property and Administrative Services Act pertaining to proceedings before Federal and State regulatory agencies; to provide grants and other Federal assistance to State and local governments for the establishment and operation of utility consumers' counsels; to provide Federal grants to universities and other nonprofit organizations for the study and collection of information relating to utility consumer matters; to improve methods for obtaining and disseminating information with respect to the operations of utility companies

1 in the Natural Gas Act, or a common carrier as defined in the
2 Communications Act of 1934.

3 (d) The term "utility service" means any service pro-
4 vided for the public by a utility.

5 TITLE I—UTILITY CONSUMERS' COUNSEL

6 ESTABLISHMENT OF OFFICE

7 SEC. 101. (a) There is hereby established within the
8 executive branch of the Government an independent agency
9 to be known as the United States Office of Utility Con-
10 sumers' Counsel (referred to hereinafter as the "Office").
11 The Office shall be headed by a Consumers' Counsel
12 (referred to hereinafter as the "Counsel"), who shall be
13 appointed for a term of five years by the President, by and
14 with the advice and consent of the Senate, and who shall
15 receive compensation at the rate provided for level 2 of the
16 Executive Schedule.

17 (b) The Counsel may—

18 (1) promulgate such rules and regulations as may
19 be required to carry out the functions of the Office; and

20 (2) delegate to any other officer or employee of the
21 Office authority for the performance of any duty im-
22 posed, or the exercise of any power conferred, upon the
23 Counsel by this Act, and any reference herein to the

1 Counsel shall include his duly authorized delegate or
2 delegates.

3 PERSONNEL AND POWERS OF THE OFFICE

4 SEC. 102. (a) The Counsel shall appoint and fix the
5 compensation of such personnel as he determines to be
6 required for the performance of the functions of the Office.

7 (b) In the performance of the functions of the Office,
8 the Counsel is authorized—

9 (1) to obtain the service of experts and consultants
10 in accordance with section 3109 of title 5 of the United
11 States Code;

12 (2) to appoint such advisory committees as the
13 Counsel may determine to be necessary or desirable for
14 the effective performance of the functions of the Office;

15 (3) to designate representatives to serve on such
16 committees as the Counsel may determine to be neces-
17 sary or desirable to maintain effective liaison with Fed-
18 eral agencies and with departments, agencies, and instru-
19 mentalities of the States which are engaged in activities
20 related to the functions of the Office; and

21 (4) to use the services, personnel, and facilities of
22 Federal and State agencies, with their consent, with or
23 without reimbursement therefor as determined by them.

24 (c) Upon request made by the Counsel, each Federal
25 agency is authorized and directed—

1 (1) to make its services, personnel, and facilities
2 available to the greatest practicable extent to the Office
3 in the performance of its functions; and

4 (2) subject to provisions of law and regulations
5 relating to the classification of information in the interest
6 of national defense, to furnish to the Office such informa-
7 tion, suggestions, estimates, and statistics as the Counsel
8 may determine to be necessary or desirable for the per-
9 formance of the functions of the Office.

10 REPRESENTATION OF PUBLIC INTEREST

11 SEC. 103. (a) Whenever there is pending in or before
12 any Federal or State agency or court any investigation,
13 hearing, or other proceeding which may, in the opinion of
14 the Counsel, affect the economic interests of consumers of
15 utility services within the United States, the Counsel may
16 intervene and, pursuant to that agency's or court's rules of
17 practice and procedure, may enter an appearance in that
18 proceeding for the purpose of representing the interests of
19 such consumers.

20 (b) Upon any such intervention, the Counsel shall pre-
21 sent to the agency or court, subject to the rules of practice
22 and procedure thereof, such evidence, briefs, and arguments
23 as he shall determine to be necessary for the effective repre-
24 sentation of the economic interests of such consumers. The
25 Counsel or any other officer or employee of the Office desig-

1 nated by the Counsel for such purpose, shall be entitled to
2 enter an appearance before any Federal agency without
3 other compliance with any requirement for admission to
4 practice before such agency for the purpose of representing
5 the Office in any proceeding.

6 REPRESENTATION OF FEDERAL GOVERNMENT INTERESTS

7 SEC. 104. (a) The Counsel shall represent the interests
8 of Federal agencies in proceedings before Federal and State
9 regulatory agencies and courts relating to rates and tariffs,
10 and in negotiations with utilities, for the procurement of
11 utility services, except that the Secretary of Defense may
12 from time to time, and unless the President shall otherwise
13 direct, exempt the National Military Establishment from the
14 provisions of this section whenever he determines such ex-
15 emptions to be in the best interests of national security.

16 (b) The Counsel shall provide the services described
17 in subsection (a) to agencies of any other branch of the
18 Federal Government, mixed ownership corporations (as de-
19 fined in the Government Corporation Control Act), or the
20 District of Columbia, upon its request.

21 (c) The functions of the Administrator of General
22 Services under section 201 (a) (4) of the Federal Property
23 and Administrative Services Act of 1949, relating to rep-
24 resenting Federal agencies in proceedings before Federal
25 and State regulatory agencies, are transferred to the Counsel,

1 insofar as such functions involve utilities as defined in this
2 Act.

3 (d) All officers, employees, property, obligations, com-
4 mitments, records, and unexpended balances of appropria-
5 tions, allocations; and other funds (available or to be made
6 available) which are determined by the Director of the
7 Bureau of the Budget to relate primarily to the functions
8 transferred pursuant to paragraph (c) are transferred to
9 the Office.

10 (e) Section 201 (a) (4) of the Federal Property and
11 Administrative Services Act of 1949 is amended by insert-
12 ing before the semicolon at the end thereof a comma and
13 the following: "except as provided in the Intergovernmental
14 Utility Consumers' Counsel Act of 1968."

15 (f) Any action being carried out by the Administrator
16 of General Services prior to the effective date of this section
17 as part of the functions transferred to the Counsel under
18 subsection (c) may be continued by the Counsel.

19 (g) This section shall become effective on the ninetieth
20 day following the date of enactment of this Act.

21 PUBLIC INFORMATION AND REPORTS

22 SEC. 105. (a) The Counsel from time to time shall
23 compile and disseminate to the public, through such publica-
24 tions and other means as he determines to be appropriate,

1 such information as he considers to be necessary or desirable
2 for the protection of the economic interests of consumers
3 of utility services.

4 (b) In January of each year, the Counsel shall trans-
5 mit to the Congress a report containing (1) a full and
6 complete description of the activities of the Office during the
7 preceding calendar year, (2) a discussion of matters cur-
8 rently affecting the economic interests of such consumers,
9 and (3) his recommendations for the solution of any prob-
10 lems adversely affecting those interests.

11 (c) The Counsel shall transmit to the President from
12 time to time such recommendations for proposed legislation
13 as the Counsel may consider to be necessary or desirable for
14 the adequate protection of the economic interests of such
15 consumers.

16 GRANTS TO STATE AND LOCAL GOVERNMENTS

17 SEC. 106. (a) The Counsel is authorized to make grants
18 to any State or local government, or combination of such
19 governments, that serve a population of one hundred thou-
20 sand or more persons, for up to 75 per centum of the cost
21 of establishing and carrying out the functions of an Office
22 of Utility Consumers' Counsel, providing such Consumers'
23 Counsel is invested with essentially the same general powers
24 and functions set forth in sections 101, 102, and 103 of this

1 Act, except as such requirements may be waived by the
2 Counsel.

3 (b) A grant authorized by subsection (a) of this sec-
4 tion may be made on application to the Counsel at such
5 time or times and containing such information as the Counsel
6 may prescribe.

7 GRANTS TO NONPROFIT ORGANIZATIONS AND UNIVERSITIES

8 SEC. 107. The Counsel is authorized to make grants
9 to colleges, universities, and other nonprofit organizations for
10 the purpose of making studies and reports, and the collect-
11 ing and dissemination of information, relating to Federal
12 and State laws, regulations, and decisions affecting consumers
13 in the fields of energy and communications.

14 TECHNICAL ASSISTANCE TO STATE AND LOCAL
15 GOVERNMENT

16 SEC. 108. The Counsel may furnish technical advice and
17 assistance, including information, on request to any State or
18 local government, college, university, or other nonprofit orga-
19 nization for the purpose of establishing and carrying out any
20 program of utility consumer interest within the general pur-
21 poses of this Act. The Counsel may accept payments, in
22 whole or in part, for the costs of furnishing such assistance.
23 All such payments shall be credited to the appropriation
24 made for the purposes of this section.

1 there is failure to comply substantially with any such
2 provision;
3 the Counsel shall notify such recipient of his findings and no
4 further payments may be made to such recipient by the Coun-
5 sel until he is satisfied that such noncompliance has been, or
6 will promptly be, corrected. However, the Counsel may au-
7 thorize the continuance of payments with respect to any
8 projects pursuant to this Act which are being carried out
9 by such recipient and which are not involved in the non-
10 compliance.

11

MODEL LAWS

12 SEC. 112. The Counsel shall make a full and complete
13 investigation and study for the purpose of—

14 (1) preparing a comparison and analysis of State
15 and Federal laws regulating utilities; and

16 (2) preparing model laws and recommendations
17 for regulation of such utilities.

18 The results of such investigation and study shall be reported
19 to the President, the Congress, and the Governor of each
20 State as soon as practicable.

21

APPROPRIATIONS AUTHORIZED

22 SEC. 113. There are authorized to be appropriated an-
23 nually for the purposes of this title an amount equal to one-

1 tenth of 1 per centum of the aggregate annual gross operat-
2 ing revenues of all utilities.

3 **SAVING PROVISION**

4 **SEC. 114.** Nothing contained in the Act shall be con-
5 strued to alter, modify, or impair any other provision of law,
6 or to prevent or impair the administration or enforcement of
7 any other provision of law, except as specifically amended or
8 to the extent that it is inconsistent with this Act.

9 **TITLE II—PUBLIC INFORMATION WITH RESPECT**
10 **TO CERTAIN UTILITIES**

11 **SEC. 201. (a)** The Federal Power Commission with
12 respect to utilities subject to its jurisdiction and the Federal
13 Communications Commission with respect to utilities subject
14 to its jurisdiction shall determine the information required
15 pursuant to subsection (b) with respect to each such utility
16 and shall publish such information at least annually in
17 reports prepared for and made readily available to the public,
18 especially in the service area of each such utility.

19 (b) The information to be made available pursuant to
20 this section with respect to each such utility shall include,
21 insofar as practicable, comparable data for previous years and
22 national averages and shall include—

23 (1) annual earnings stated as a rate of return on
24 a depreciated average original cost rate base and pur-

1 suant to other accounting principles and practices of the
2 relevant Federal commission;

3 (2) annual earnings in dollars as determined pur-
4 suant to clause (1) ;

5 (3) the dollar difference between amounts deter-
6 mined pursuant to clause (2) and the annual earnings
7 if the utility earned 6 per centum rate of return on the
8 rate base determined pursuant to clause (1) ;

9 (4) capital structure stated as percentage of capi-
10 talization obtained from long-term debt, preferred stock,
11 common stock, and earned surplus;

12 (5) average rate of interest on long-term debt;

13 (6) rate of return on average common stock
14 equity;

15 (7) yearend yield on common stock (annual com-
16 mon dividend divided by yearend market price) ;

17 (8) dividend on preferred stock;

18 (9) yearend preferred dividend yield (annual pre-
19 ferred dividend divided by yearend market price of
20 preferred stock) ;

21 (10) yearend earnings price ratio (earnings per
22 share divided by yearend price per share) ;

23 (11) the names and addresses of the one hundred
24 principal stockholders including, in those cases where

1 voting stock is held by a party other than the beneficial
2 owner, the name and address of each beneficial owner
3 of 1 per centum or more of the voting stock in the
4 corporation;

5 (12) the name and address of each officer and
6 director and his annual income from the utility and its
7 parent or subsidiary corporations, if any;

8 (13) the names and addresses of other corporations
9 of which such officers and directors are also officers or
10 directors;

11 (14) the names of directors, if any, who were
12 not nominated by the management of the utility;

13 (15) terms of restricted stock option plans avail-
14 able to officers, directors, and employees (not to in-
15 clude plans available to all employees on equal terms)
16 and including name, title, salary, and retirement benefits
17 of each person to whom stock options have been
18 granted, number of options each has exercised, date
19 on which options were exercised, option price of the
20 stock and market price of the stock when option was
21 exercised;

22 (16) all payments included in any account for
23 rate, management, construction, engineering, research,
24 financial, valuation, legal, accounting, purchasing, ad-
25 vertising, labor relations, public relations, professional

1 and other consultative services rendered under writ-
2 ten or oral arrangements by any corporation, partner-
3 ship, individual (other than for services as an em-
4 ployee), or organization of any kind, including legislative
5 services;

6 (17) policy with respect to deposits of customers
7 and service connection charges, if required;

8 (18) rate of interest charged customers by the
9 utility, stated as simple annual interest;

10 (19) rate base valuation and components of the
11 utility's rate base, as determined by the State commis-
12 sion having jurisdiction, expressed in dollar amounts, and
13 including amount permitted in rate base in each of the
14 following categories: accumulated tax deferrals, allow-
15 ance for working capital, construction work in progress,
16 customers' advances, materials and supplies, plant acqui-
17 sition adjustment, and plant held for future use;

18 (20) rate base valuation and components of the
19 utility's rate base, as determined by the Federal com-
20 mission having jurisdiction, expressed in dollar amounts;

21 (21) dollar difference in each category and in sum,
22 between the rate base as computed pursuant to clauses
23 (19) and (20);

24 (22) terms of franchises or certificates of conven-
25 ience and necessity;

1 (23) with respect to contracts for purchase of coal,
2 the following information: sales company, producing
3 company, producing mine, tonnage, price free on board
4 at mine, transportation cost, total cost at plant; cost per
5 ton;

6 (24) a summary of terms of pooling, interconnec-
7 tion and exchange agreements; and

8 (25) such other information as the appropriate
9 Federal commission determines to be in the public
10 interest.

11 Such information shall be determined on a fiscal or calendar
12 year basis as may be appropriate and shall be reported as
13 soon as practicable after the termination of such year.

14 (c) The Federal Power Commission and the Federal
15 Communications Commission are each authorized to estab-
16 lish such regulations as may be necessary to obtain informa-
17 tion needed for the purposes of this section and the violation
18 of such regulations shall be deemed to be a violation of
19 regulations pursuant to the Federal Power Act, with respect
20 to the utilities subject to such Act, the Natural Gas Act,
21 with respect to utilities subject to such Act, or the Communi-
22 cations Act of 1934, with respect to utilities subject to such
23 Act, respectively.

INTERIM REPORT OF THE ADMINISTRATIVE CONFERENCE OF THE UNITED STATES

January 15, 1969

FOREWORD

This Interim Report of the Administrative Conference of the United States covers the period from the time when the organization of this new independent agency was begun in January 1968 through December 31, 1968.

It briefly explains the background and describes the organization, membership and activities of the Conference.

The texts of the recommendations approved at the Second Plenary Session of the Conference on December 10-11, 1968, are set forth in full. The recommendations and full texts of the supporting committee reports will be published in the Annual Report of the Administrative Conference for fiscal year 1969.

THE ADMINISTRATIVE CONFERENCE OF THE UNITED STATES

On August 30, 1964, President Lyndon B. Johnson signed Public Law 88-499, 5 U.S.C. 571-576, which authorized the establishment of the Administrative Conference of the United States as a new independent Federal agency. The agency is comprised of a sizeable deliberative body of top-level Government officials and persons of national reputation in law and government drawn from the private sector. Its mission is to work on a continuing basis toward the development of improvements in the Federal administrative process -- that vast complex of legal procedures which the Federal Departments and agencies use to determine the rights, privileges, and obligations of individual citizens and private businesses.

There are some thirty departments and agencies which conduct the bulk of administrative proceedings affecting private rights. These proceedings are of infinite variety. They range from the grant of a television license worth millions of dollars to the processing of applications for amateur or citizen band licenses; from the processing of an application to merge railroads of the magnitude of the New York Central and the Pennsylvania to authorizing truck transportation of a particular commodity over a particular route; or from the approval of a prospectus for a major new corporation to permitting cattle to graze on Federal lands. Because of this steady flow of Federal agency determinations affecting our natural resources, transportation, power, finance, communications, commerce, securities, taxation, labor, credit, advertising, housing, veterans benefits, the supply, quality, and price of food and fibers, public health, immigration, social welfare programs, drug control, and countless other areas of activity, the administrative process, in one way or another, continuously exerts its influence upon every citizen in his personal and business affairs.

For a number of years the adequacy of the governmental processes through which these programs are administered has been a matter of increasing concern, both public and private. The rising volume of proceedings has resulted in some paralyzing backlogs, and in many areas excessive delays in official action have severely prejudiced private undertakings and perhaps slowed the national economy generally. Frequently, attempts

at across-the-board solutions have not adequately taken into account the variety of private interests affected, with resulting unfairness to many. At times, limitations on the access to public information have brought into question the integrity of particular actions. And the expense of official processes, to the Government and to the private interests involved, has been staggering.

Development of the idea of an Administrative Conference as the best means to improve agency procedures spans almost 20 years. During this period two temporary, experimental Administrative Conferences were held, the first on the call of President Eisenhower in 1953, the second in 1961 by President Kennedy. Both Conferences were chaired by Judge E. Barrett Prettyman of the United States Court of Appeals for the District of Columbia Circuit. Both Conferences recommended that a permanent Administrative Conference authorized by statute be created. Legislation for this purpose was introduced in the 88th Congress, and was duly enacted.

ORGANIZATION AND MEMBERSHIP

On October 14, 1967, President Johnson nominated Jerre S. Williams of the faculty of the University of Texas Law School to be the first Chairman of the Administrative Conference, an appointment that was confirmed by the Senate on October 19, 1967. The organization of the new agency began on January 8, 1968, when the Chairman arrived in Washington to establish offices, although his formal swearing-in took place on January 25, 1968.

On February 7, 1968, the President announced his appointment of the other ten members of the Council, the executive board of the Conference. Five of these appointees were from Government and five from outside of Government.

The Act provides that the Administrative Conference shall consist of not more than 91 nor less than 75 members. Excluding the Council, 60% to two-thirds of the members must be Government representatives from the departments and agencies. The

remaining members are private citizens who contribute their time and effort to working with the departments and agencies to improve their procedures.

On April 24, 1968, the White House designated the Executive Departments and agencies to have membership in the Assembly of the Conference. The twelve Cabinet Departments were so designated, plus ten agencies, which together with the agencies participating under the terms of the Administrative Conference Act and those represented in the Council membership, brought the total number of agencies participating to thirty-four. At the same time, the White House announced the names of the 32 persons who were to be members from the private sector, appointed by the Chairman of the Conference with the approval of the Council. Shortly thereafter each of the departments and agencies which had been designated to participate announced the names of the officials who would serve as members.

The membership of the Conference as now constituted appears as Appendix A.

ACTIVITIES OF CONFERENCE

The Conference held its first plenary session on May 27, 1968. It was addressed by the Attorney General of the United States, Ramsey Clark, and by Judge E. Barrett Prettyman. The session was largely of an organizational nature. Bylaws were adopted. Ten Standing Committees to study particular areas of the administrative process were established and a Chairman was appointed to each. Each committee was provided the services of a law professor to work with it toward the development of recommendations for Conference consideration.

By late fall enough proposed recommendations had been developed to justify a second plenary session which was held on December 10-11, 1968. The Assembly was addressed by Associate Justice Tom C. Clark, Director of the Federal Judicial Center.

The Assembly adopted eight recommendations, the texts of which appear as Appendix B.

At this second meeting of the Assembly, the Chairman of each of the ten Standing Committees made a report on pending and proposed projects. Among the more significant studies to be undertaken in the future are the evaluation of the important role of hearing examiners; elimination of delay through enlarged delegation of final decision-making authority; greater use of rulemaking as a substitute for adjudication on the record; development of new techniques to speed licensing procedures; use of discovery in adjudicatory proceedings; publication of a manual on the trial of protracted cases; and greater uniformity and simplicity in judicial review procedure.

The Third Plenary Session of the Administrative Conference is tentatively scheduled for the late spring of 1969.

In his opening remarks at the first plenary session of the Administrative Conference, May 27, 1968, Judge E. Barrett Prettyman said:

"It is all very well to have theories, but I am devoted to the thesis that government is supposed to work. Our administrative system works pretty well, but in lots of cases it has substantial flaws: it costs too much; it takes too long; and the process is too cumbersome.

"This conference has the opportunity to make the administrative part of a democratic system of government work. You could not have a greater opportunity."

The opportunity to make the administrative machinery work is a challenge which the Administrative Conference accepts and will endeavor to fulfill.

May 20, 1969

APPENDIX A

MEMBERS OF THE CONFERENCE

Jerre S. Williams, Chairman

Council

Frank M. Wozencraft, Vice Chairman
Baker, Botts, Shepherd & Coates
Houston, Texas

Leonard H. Marks
Cohn and Marks
Washington, D. C.

Willard Deason
Commissioner
Interstate Commerce Commission

Edward L. Morgan
Deputy Counsel to the President
The White House

Walter Gellhorn
Professor
Columbia Law School

Harold L. Russell
Gambrell, Russell, Moye & Killorin
Atlanta, Georgia

Rosel H. Hyde
Chairman
Federal Communications Commission

Whitney North Seymour, Sr.
Simpson, Thacher & Bartlett
New York, New York

Joe M. Kilgore
McGinnis, Lochridge, Kilgore,
Byfield, Hunter & Wilson
Austin, Texas

Richard C. Van Dusen
Under Secretary
Department of Housing and
Urban Development

MEMBERS OF THE CONFERENCECarolyn E. Agger (Miss)Arnold & Porter
Washington, D. C.C. Paul BarkerDodd, Hirsch, Barker & Meunier
New Orleans, LouisianaSt. John BarrettDeputy General Counsel
Department of Health, Education,
and WelfareFrank A. BartimoAssistant General Counsel (M&RA)
Department of DefenseCharles F. BrannanGeneral Counsel
National Farmers Union
Denver, ColoradoCharles W. BucyAssistant General Counsel
Department of AgricultureJ. W. BullionThompson, Knight, Simmons & Knight
Dallas, TexasClark ByseProfessor
Harvard Law School
Cambridge, MassachusettsJohn T. ChadwellChadwell, Keck, Kayser, Ruggles
& McLaren
Chicago, IllinoisHarold J. CohenGeneral Attorney
American Telephone & Telegraph
Company
New York, New YorkDonald C. CookPresident
American Electric Power
Company, Inc.
New York, New YorkArthur H. CourshonChairman of the Board
Washington Federal Savings and
Loan Association of Miami
Beach
Miami Beach, FloridaJohn H. Crooker, Jr.Chairman
Civil Aeronautics BoardWilliam J. CurtinMorgan, Lewis & Bockius
Washington, D. C.Kenneth Culp DavisProfessor
University of Chicago Law School
Chicago, IllinoisPaul Rand DixonChairman
Federal Trade CommissionDavid C. EberhartDirector of the Federal Register
General Services AdministrationNorman A. FlaningamAttorney at Law
Washington, D. C.

MEMBERS OF THE CONFERENCEThomas J. Flavin

Judicial Officer

Department of Agriculture

Jefferson B. Fordham

Dean

University of Pennsylvania
Law School

Philadelphia, Pennsylvania

Robert P. Forrestal

Assistant Secretary

Federal Reserve System

Warner W. Gardner

Shea & Gardner

Washington, D.C.

William T. Gennetti

Acting General Counsel

Small Business Administration

Howard A. Glickstein

Acting Staff Director

U.S. Commission on Civil Rights

George A. Graham

Executive Director

National Academy of Public
Administration

Washington, D.C.

Robert W. GrahamBogle, Gates, Dobrin, Wakefield &
Long

Seattle, Washington

Dale W. Hardin

Commissioner

Interstate Commerce Commission

John Harllee (Admiral)

Chairman

Federal Maritime Commission

Patricia Harris (Mrs.)

Professor

Howard University Law School
Washington, D.C.Ferrel Heady

President

University of New Mexico
Albuquerque, New MexicoLewis B. Hershey (General)

Director

Selective Service System

Arthur E. HessDeputy Commissioner of Social
SecurityDepartment of Health, Education,
and WelfareS. Neil Hosenball

Deputy General Counsel

National Aeronautics and Space
AdministrationRichard H. Keatinge

Keatinge & Sterling

Los Angeles, California

John T. Koehler

Butler, Koehler & Tausig

Washington, D.C.

Jim C. Langdon

Chairman

Texas Railroad Commission
Austin, TexasArthur W. Leibold, Jr.

General Counsel

Federal Home Loan Bank Board

Sol LindenbaumExecutive Assistant to the
Attorney General

Department of Justice

MEMBERS OF THE CONFERENCE

Charlotte Tuttle Lloyd (Mrs.)
Assistant General Counsel
Department of the Treasury

Philip A. Loomis, Jr.
General Counsel
Securities & Exchange Commission

J. Edward Lyerly
Deputy Legal Adviser for
Administration
Department of State

Frank W. McCulloch
Chairman
National Labor Relations Board

Ross L. Malone
Vice President and General Counsel
General Motors Corporation
New York, New York

Malcolm Mason
Associate General Counsel
Office of Economic Opportunity

Wilson Matthews
Director, Hearing Examiners Office
U.S. Civil Service Commission

Mitchell Melich
Solicitor
Department of the Interior

James B. Minor
Assistant General Counsel for
Regulation
Department of Transportation

Nathaniel L. Nathanson
Professor
Northwestern University School
of Law
Chicago, Illinois

David A. Nelson
General Counsel
Post Office Department

C. Roger Nelson
Purcell & Nelson
Washington, D. C.

Leonard Niederlehner
Acting General Counsel
Department of Defense

Nathan Ostroff
Chairman
Appeals Board
Department of Commerce

Max D. Paglin
Executive Director
Federal Communications Commission

Samuel R. Pierce, Jr.
Battle, Fowler, Stokes & Kheel
New York, New York

Edwin F. Rains
Deputy Commissioner of Customs
Department of the Treasury

James T. Ramey
Commissioner
U.S. Atomic Energy Commission

Emmette S. Redford
Professor of Government
University of Texas
Austin, Texas

Charles S. Rhyne
Rhyne & Rhyne
Washington, D. C.

George Robinson
Deputy Assistant Secretary for
Administration
Department of the Interior

MEMBERS OF THE CONFERENCE

Merritt Ruhlen
Hearing Examiner
Civil Aeronautics Board

Howard Schnoor
Director
Government Organization Staff
Bureau of the Budget

Bernard G. Segal
Schnader, Harrison, Segal &
Lewis
Philadelphia, Pennsylvania

Ashley Sellers
Sellers, Conner & Cuneo
Washington, D. C.

Laurence H. Silberman
Solicitor of Labor
Department of Labor

Daniel Steiner
General Counsel
Equal Employment Opportunity
Commission

A. W. Stratton
Deputy Administrator of
Veterans Affairs
Veterans Administration

Starr Thomas
Vice-President - Law
Santa Fe Railway
Chicago, Illinois

Sherman Unger
General Counsel
Department of Housing and
Urban Development

Thomas H. Wall
Dow, Lohnes & Albertson
Washington, D. C.

Howard C. Westwood
Covington & Burling
Washington, D. C.

Lee C. White
Chairman
Federal Power Commission

MEMBERS OF PROFESSIONAL STAFF

John F. Cushman, Executive Director
Webster P. Maxson, Executive Secretary
David E. Kartalia, Staff Attorney
Margie W. Barnes, Executive Assistant
Ruth M. Hartman, Confidential Secretary
William L. Banks, Clerk
Marilyn L. Cleek, Clerk-Typist

APPENDIX B

RECOMMENDATIONS
of
SECOND PLENARY SESSIONDecember 10 - 11, 1968
Washington, D.C.Recommendation No. 1 - Adequate Hearing Facilities

Administrative hearings of the Federal government should be conducted in dignified, efficient hearing rooms, appropriate as to size, arrangement, and furnishings. At the present time no central body is responsible for providing or planning the needed facilities. As a particular consequence, administrative hearings often have been conducted in surroundings unsuitable to the seriousness of these governmental proceedings. The General Services Administration could advantageously arrange for the service and the space needed by departments and agencies in which administrative hearings occur.

RECOMMENDATION

1. The General Services Administration should develop a set of four hearing room classifications explicitly identifying the features required with standards meeting at least the following minimum requirements. Such classifications should be developed in conjunction with representatives of the agencies, the bar, and examiners. The minimum requirements should be:

Type A - A formal conference room with table space for as many as 16 principals and additional seating for up to 20 other persons.

Type B - A small hearing room with a raised dais, a witness box, a reporter's table, table space for as many as 6 counsel, and additional seating for up to 30 others. The design and furnishings should be appropriate to a hearing which is judicial in

nature and should include wherever possible an auxiliary room in which counsel may confer with their clients, witnesses may be sequestered, etc.

Type C - A large hearing room accommodating as many as 30 counsel at tables and up to 70 witnesses and spectators. This room should have the design and furnishings which are appropriate to formal hearings of a judicial nature.

Type D - An auditorium suitable for hearings of general public interest which might attract over 100 principals and spectators.

An essential requirement of each of the four types of hearing rooms should be a small, near-by room available to the examiner as his office and for such other uses as he designates.

2. The General Services Administration should prepare and maintain on a current basis an inventory which (a) identifies available hearing facilities throughout the country, classified under the system recommended in 1 above, including hearing rooms permanently assigned to particular agencies as well as court-rooms (local, state, and Federal), (b) identifies the GSA regional offices, local building managers, and others through whom such space can be obtained, and (c) provides information concerning the procedures to be followed to obtain space through the GSA for the conduct of hearings.

3. The General Services Administration should establish procedures for determining the frequency and location of administrative hearings which require facilities of each type within the system of classification recommended above in order to determine, by city, whether a permanent hearing room for multi-agency use can be justified. A permanent hearing room should be considered justified wherever there is a continuing need of approximately one-fourth of the available working days.

4. The General Services Administration should provide for the administration and scheduling of permanent multi-agency hearing facilities under the direction of GSA's Washington headquarters, but subject to such decentralization as the functions of inventorying, procuring, and planning may require.

5. The General Services Administration should establish a procedure for the systematic reporting, to the respective agency and to GSA, of deficiencies in assigned facilities discovered by presiding officers, and for the investigation and correction of such deficiencies.

6. The General Services Administration should establish an advisory committee of members of the bar and other interested professional associations, agency representatives, and members of the public to facilitate the evaluation of present and future needs and to report annually to the Administrative Conference on its activities.

7. Permanent multi-agency hearing rooms and hearing rooms permanently assigned to individual Federal agencies should be identified as "Federal Administrative Hearing Rooms."

8. The Chairman of the Administrative Conference should encourage the cooperation of state and local judges in the procurement of courtroom space for Federal administrative hearings.

9. The Judicial Conference of the United States should encourage the cooperation of Federal judges in the procurement of courtroom space for Federal administrative hearings.

10. Federal agencies should budget funds to provide for the payment of charges for the use of appropriate space when such space is not available on a free basis.

11. Federal agencies which conduct administrative hearings should designate an official to work with the General Services Administration in the procurement and planning of hearing facilities.

Recommendation No. 2 - U. S. Government Organization Manual

The Manual at present falls short of its goal because the narrative text submitted by some of the agencies is outdated, unrevealing, cumbersome, or otherwise deficient. The text should be rewritten at a high level of competence.

RECOMMENDATION

1. Each agency covered by 5 U.S.C. 552 should assign the writing of material for the United States Government Organization Manual to an office having the competence to achieve the brevity, clarity, and general excellence of presentation required to serve the purpose of this handbook and to reflect credit on our government.

2. Included in the description of each agency should be information concerning the means by which more detailed knowledge of the agency's organization and functions may be obtained.

Recommendation No. 3 - Parallel Table of
Statutory Authorities and Rules (2 CFR Ch. I)

The Parallel Table of Statutory Authorities and Rules (2 CFR Ch. I) should be an accurate and complete listing of United States Code provisions cited as rulemaking authority in executive agency documents which prescribe general and permanent rules. The present Parallel Table is deficient. Agencies have not given sufficient time and attention to citing proper authorities and to keeping them current. Moreover, the Table's present method of preparation leads to omission of relevant references.

RECOMMENDATION

1. Each agency covered by 5 U.S.C. 552 should review all of its rules published in the Code of Federal Regulations to determine if the cited rulemaking authorities are complete, accurate, and current. The Conference requests that formal documents correcting deficient citations be submitted to the Office of the Federal Register for publication in the daily Federal Register.

2. The Office of the Federal Register should take the steps necessary to broaden the coverage of the Table to include pertinent citations in preambles and in codified text as well as those in the formal statements of authority.

Recommendation No. 4 - Consumer Bulletin

Most Americans are probably unaware of the multitude of day-to-day Federal activities reflected in proposed, revised, and recently promulgated rules, regulations, or determinations which substantially affect the price, quantity, quality, labeling, safety, and other aspects of products and services available to the public. A bulletin of general distribution containing an easily understood summary of current information about administrative activities in areas of consumer interest could serve a widespread public need which is not now met by the Federal Register or by agency and private publications of a more specialized nature.

RECOMMENDATION

1. A consumer bulletin should be established on an experimental basis. It should extract and paraphrase in popular terms the substance of Federal agency actions of significant interest to consumers. Initially, the bulletin should concentrate on items published in the Federal Register, but as it gains public acceptance, it should be broadened to include materials secured from other sources. It should indicate expressly that the bulletin does not constitute official notice of government action.
2. The Office of the Consumer Counsel in the Department of Justice appears at this time to be the agency best prepared to publish such a bulletin. If the bulletin were undertaken by that Office, it could not only disseminate information, but also stimulate public response, thus aiding the effective discharge of the duties of the Consumer Counsel.
3. Initial circulation should include the press, consumer organizations, public and scholastic libraries, and individuals who request to be put on the mailing list. Format, subscription costs, frequency of publication, and related matters should be the subject of study during the experiment.
4. After a reasonable period of time, the effectiveness of and interest in the bulletin should be evaluated to determine whether it should be continued and, if so, in what form.

Recommendation No. 5 - Representation of the Poor in Agency
Rulemaking of Direct Consequence to Them.

RECOMMENDATION

A. Agency Efforts

1. Federal agencies should engage more extensively in affirmative, self-initiated efforts to ascertain directly from the poor their views with respect to rulemaking that may affect them substantially. For this purpose, agencies should make strong efforts, by use of existing as well as newly devised procedures, to obtain information and opinion from those whose circumstances may not permit conventional participation in rule-making proceedings. The "rulemaking" referred to is that defined by the Administrative Procedure Act, §2(c), 5 U.S.C. 551(4) and (5).

2. Agencies should employ as many of the following procedures as are feasible, practicable, and necessary to assure their being fully informed concerning the relevant interests of the poor:

- (a) Agencies should seek to inform the poor of all rulemaking proposals that may affect them substantially and should provide opportunities for the poor to submit their views concerning these and related proposals.
- (b) Agencies should hold formal public hearings or informal conferences in close geographic proximity to the poor substantially affected by contemplated rule-making.
- (c) Agencies should take care to invite individuals constituting a representative cross-section of the poor to submit their views orally or in writing as to proposed rules substantially affecting the poor.
- (d) Agencies should conduct field surveys among the poor to discover their attitudes concerning particular government policy-making substantially affecting them.

(e) Agencies should use advisory committees made up of representatives of the poor as continuing consultants for all programs having a substantial effect on such persons.

(f) When necessary to assure adequate representation for the poor, agencies should pay the personal expenses and wage losses incurred by individuals incident to their participation in rulemaking hearings. Congress should support agency requests for funds and for authority, where none exists, to make discretionary payments for this purpose. Agencies already authorized to make such payments in whole or in part should use their existing authority and should allocate funds accordingly.

In deciding whether the use of any one or more of the above devices is feasible, practicable, or necessary in a given situation, agencies should resolve doubts in favor of utilizing them; but their enumeration should not exclude or discourage the development and use of other devices to achieve the same result.

In carrying out paragraphs 1 and 2 of this Recommendation, agencies should consult with and coordinate their efforts with other Federal agencies having responsibilities in this area and should make maximum feasible use of the facilities of such other agencies for communicating with and obtaining expressions of the views of the poor.

3. Agencies should be encouraged in appropriate circumstances to determine that the exemptions in 5 U.S.C. 553(a)(2) should not be applied with respect to rulemaking which may have a substantial impact on the poor.

B. People's Counsel

4. (a) An organization should be authorized by statute to employ a staff to act as "People's Counsel." The People's Counsel should represent the interests of the poor in all Federal administrative rulemaking substantially affecting the poor.

(b) The People's Counsel should be charged with assuring that the views of significant separable minority interests among the poor are represented in such Federal administrative rulemaking.

(c) The People's Counsel should be required to disseminate to all interested poor people's organizations pertinent information concerning rulemaking substantially affecting the poor.

(d) The People's Counsel should be authorized to participate suitably in its own name to represent the interests of the poor in any Federal agency proceedings in which the poor have a substantial interest.

(e) The People's Counsel should be authorized to provide representation for organizations and groups of the poor who seek judicial review of administrative action substantially affecting their interests. This recommendation is not to alter the kinds of agency action amenable to judicial review, the requirements of standing to seek review, or the scope of that review.

(f) As an incident to its main responsibilities the People's Counsel should be empowered to recommend to Congress or the President or to both such legislation or other action as it deems appropriate to correct deficiencies in or otherwise improve Federal programs having a substantial impact on the poor.

5. (a) Congress should provide for an appropriate body to perform the functions outlined in Section 4. Deserving of consideration as such body would be a new single-purpose corporation, to be created by Congress, modeled on the Corporation for Public Broadcasting, Pub. Law 90-129, 81 Stat. 368 (1967), 47 U.S.C. (Supp. III) 396, and to be known as the People's Counsel Corporation. In the event this form of organization is adopted, the following considerations should apply:

(1) The People's Counsel Corporation should be made tax exempt and authorized to accept grants of private funds. Gifts to the Corporation should be made deductible as charitable contributions for Federal income tax purposes.

(2) Federal financing of the Corporation should be made available to the extent necessary to assure its effective operation.

(3) The governing board of the People's Counsel Corporation should be constituted to give the poor meaningful representation thereon. Such body should be constituted to ensure close communication with the poor and effective representation of the viewpoints of the poor.

6. All Federal agencies should be required by Executive order to notify the People's Counsel of all proposed rules which would have a substantial impact on the poor. Agencies also should be required by that Executive order to give the People's Counsel an opportunity to present the views of the poor with respect to such proposed rules. Exceptions to these obligations should be permitted only "when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefor in the rules issued) that such notice and . . . an opportunity for the People's Counsel to present its views are impracticable, unnecessary, or contrary to the public interest." (See 5 U.S.C. 553(b)(B).) In these exceptional cases, agencies should be required to notify the People's Counsel as soon as practicable of any consummated rulemaking substantially affecting the poor, and should be required to give the Counsel as soon as practicable an opportunity to communicate to the agency its views concerning the desirability of further action with respect to such rule-making.

Without prejudice to creating or empowering any other appropriate body to perform the general functions outlined in paragraphs 4, 5, and 6, any special provision therefor should be so structured as to take maximum advantage of the capabilities in this field of non-government organizations, and of other public bodies, including notably the Office of Economic Opportunity.

SEPARATE STATEMENTS CONCERNING
RECOMMENDATION NO. 5 - REPRESENTATION OF THE POOR IN AGENCY
RULEMAKING

Statement of John H. Crooker, Jr.

The majority position with respect to Recommendation No. 5 is that "Federal agencies" should make strong efforts to ascertain from the poor their views regarding rulemaking "that may affect them substantially." I believe that (a) the major independent agencies are seldom involved in rulemaking affecting the poor except insofar as the poor are members of the public generally; and (b) it was the intent of the Congress, in establishing the Administrative Conference, to have studies conducted and information collected and interchanged, so that administrative agencies might improve and expedite their general procedures.

Therefore, I doubt that the Congress, in enacting section 5 of the Administrative Conference Act, 5 U.S.C. 574, intended that the Conference should address itself to the matters treated in Recommendation No. 5. My dissent is not, in any way, directed to the wording of the recommendation.

Statement of Paul Rand Dixon

I disagree with the adoption of paragraphs 4, 5, and 6 of Recommendation No. 5 developed by the Committee on Rulemaking respecting the creation of a People's Counsel to represent the poor generally before Federal administrative bodies. I am fully aware of and sympathetic with the plight of the poor in our society. I recognize it as one of the primary problems that must be solved if our democratic way is to survive. However, I am fully of the opinion that this is a problem that should be debated and resolved by Congress. I find nowhere in the legislative history leading to the creation of the Administrative Conference of the United States any thought that the Administrative Conference would delve into this social problem. Even if I could bring myself to the thought that it was rightfully within the purview of the duties of the Administrative Conference to deal with the plight of the poor, I still would question the wisdom of creating a Poor People's Counsel as the sole, if not principal, protector of the rights of the poor. The plight of the poor needs everyone's protection, not just the protection of a People's Counsel.

Statement of Paul Rand Dixon (Continued)

So that my position will not be misunderstood, I want it clearly known that I stand in the forefront of those who deem it necessary to do more to protect those low-income people in our society who are generally classified as poor.

Statement of Joe M. Kilgore, joined by
 Richard H. Keatinge
 Jim C. Langdon
 Norman A. Flaningam *
 Ross L. Malone
 Starr Thomas
 Harold L. Russell

We did not support paragraphs 4, 5, and 6 of Recommendation No. 5. We do support encouraging the formation of and recognition of a People's Counsel, as a private entity, to represent the public interest in the area of rulemaking in Federal agencies; with such Counsel being oriented to represent most fully those of the public whose interests would otherwise be un-represented or under-represented; and with such People's Counsel being eligible to receive Federal grants as required to permit its function.

This dissent from the majority view is dictated by:

1. The concern that this proposed function should be restricted, at least until experience might dictate otherwise, to the rulemaking function.
2. The belief that the proposed representation should not be limited to any segment of the public, even though its principal thrust would be so directed.

* Mr. Flaningam joins in this statement noting that the term "rulemaking" as used therein refers to Federal agency processes for formulation, amendment, or repeal of rules of general applicability.

Statement of Malcolm S. Mason

I support the purposes of this recommendation. When a People's Counsel is constituted, however, it is important to make a distinction between two kinds of advocacy, so different that they cannot be directly conducted by the same organization. There is first of all adversary advocacy, owing an attorney's complete loyalty to a specific client. In this sense, there cannot be a People's Counsel for the poor, because the poor are many and different and must be able to speak with many voices. This kind of advocacy is needed. It must be aggressive and hard-hitting. If it is conducted directly by a Government or Government-controlled agency, its independence may be impaired. For this kind of advocacy an appropriate model is suggested by the Legal Services Program conducted by many separate private local organizations: funded by OEO, but free, and indeed encouraged, to act fully on behalf of an actual client without limiting its vigor by reason of relationship to OEO. This, I believe, will also be the pattern of the new HEW Legal Services Program.

There is also cooperative advocacy: unaggressive, quiet, nonadversary, seeking to foster an awareness, a concern and a more lively recognition that poor people are affected by proposed administrative action. This kind of advocacy can be conducted by a Government or quasi-Government organization without inconsistency and with benefit to the effectiveness of its work. An appropriate model is suggested by such accomplishments as new rules on loans to demonstration cooperatives of poor farmers (achieved by mutual agreement of the Department of Agriculture and OEO); new clarification of Government security regulations, removing barriers to the employment of hard-core unemployed with a criminal record (achieved by joint action of the Department of Defense, Department of Labor and OEO); a new consensus on the wider use of policy advisory boards in programs affecting the poor (resulting in part from encouragement of this kind of action by OEO).

I urge that the Conference Recommendation be implemented. In its implementation, contributions already made in this field should be recognized and used as a basis for expanded activity. The distinction between the two different types of advocacy should also be reflected in the choice of appropriate structure. Both are needed.

Statement of Nathaniel L. Nathanson

I would like to explain why I voted in favor of the recommendation for a People's Counsel, as amended during the debate, because I believe that my interpretation of the final action taken may have been shared by others who also voted in favor of the proposal and is therefore entitled to some consideration in efforts to secure its implementation.

While I was deeply troubled by some of the arguments advanced against the proposal, particularly by the misgivings expressed concerning the arrogance of a government agency or public corporation undertaking to determine the interests of the poor in particular agency action, I felt that this concern could be met by emphasis upon the representative character of the People's Counsel and a requirement that specific, identifiable interests be represented, rather than hypothetical interests which might be imagined by the People's Counsel. This requirement could appropriately be implemented by the further requirement that those interests be identified in the form of particular groups or associations who could determine their own interests and make their own wishes or basic positions known to the People's Counsel. This view was certainly made explicit in the amendment proposed by the Judicial Review Committee and accepted by the Rulemaking Committee, to paragraph 4(e) and it is also consistent with the final language of paragraph 4(d) as amended in the course of the debate so as to substitute "participate suitably" for the original word "intervene." This left a large measure of discretion to each agency in allowing participation by the People's Counsel in a particular proceeding, including the requirement of a showing that the concern or position which the People's Counsel undertook to present was in fact shared by an identifiable group of people who were at least informed of the position which the People's Counsel was taking. I also doubt that the leaders of the Poor People's movement who were quoted by Professor Bonfield as favorable to the proposal envisaged a People's Counsel who would not be in any way answerable to the people he undertook to represent.

I appreciate that this interpretation, emphasizing as it does the representation of identifiable groups who may exercise some control over the People's Counsel, may not be entirely acceptable to the original proponents of the proposal, particularly those who accepted the amendments with some reluctance. Nevertheless, they did accept the amendments, presumably for the purposes

of mollifying the opposition and with some appreciation of the fact that the reasons for the amendments were more than technical. Particularly in view of the closeness of the vote on the final approval of paragraphs 4, 5, and 6, the original proponents are hardly now in a position to insist upon the rejection of a reasonable interpretation which may have been decisive in the approval of the recommendation. They may also take some comfort in the fact that the current requirements for standing to participate in both administrative and judicial proceedings by groups indirectly affected by governmental action will scarcely inhibit the activities of a People's Counsel anxious and resourceful enough to find out what the people he purports to represent really want.

Statement of Robert W. Graham

May I respectfully record my dissent from the recommendations of the Conference embodied in paragraphs 4, 5, and 6 of Recommendation No. 5. No one can disagree with the stated objectives of these recommendations, and I do not. However, I do not conceive that these recommendations are appropriate within the mission of the Administrative Conference in its efforts to seek improvement of administrative procedures. Furthermore, I consider unsound attempts to fractionate the public interest which is properly the concern of our Federal administrative agencies.

Recommendation No. 6. - Delegation of Final Decisional Authority
Subject to Discretionary Review by the Agency

RECOMMENDATION

1. In order to make more efficient use of the time and energies of agency members and their staffs, to improve the quality of decision without sacrificing procedural fairness, and to help eliminate delay in the administrative process, every agency having a substantial caseload of formal adjudications should consider the establishment of one or more intermediate appellate boards or the adoption of procedures for according administrative finality to presiding officers' decisions, with discretionary authority in the agency to affirm summarily or to review, in whole or in part, the decisions of such boards or officers.

2. Section 8 of the Administrative Procedure Act, 5 U.S.C. 557, should be amended as necessary to clarify the authority of agencies to restructure their decisional processes along either of the following lines:

(a) Intermediate appellate boards

- (1) Whenever an agency deems it appropriate for the efficient and orderly conduct of its business, it may, by rule or order:
- (A) establish one or more intermediate appellate boards consisting of agency employees qualified by training, experience, and competence to perform review functions,
 - (B) authorize these boards to perform functions in connection with the disposition of cases of the same character as those which may be performed by the agency,
 - (C) prescribe procedures for review of subordinate decisions by such boards or by the agency, and

- (D) restrict the scope of inquiry by such boards and by the agency in any review, without impairing the authority of the agency in any case to decide on its own motion any question of procedure, fact, law, policy, or discretion as fully as if it were making the initial decision.
- (2) Any order or decision of an intermediate appellate board, unless reviewed by the agency, shall have the same force and effect and shall be made, evidenced, and enforced in the same manner as orders and decisions of the agency.
 - (3) A party aggrieved by an order of such board may file an application for review by the agency within such time and in such manner as the agency shall prescribe, and every such application shall be passed upon by the agency.
 - (4) In passing upon such applications for review, an agency may grant, in whole or in part, or deny the application without specifying any reasons therefor. No such application shall rely upon questions of fact or law upon which the intermediate appellate board has been afforded no opportunity to pass.
 - (5) An agency, on its own initiative, may review in whole or in part, at such time and in such manner as it shall determine, any order, decision, report, or other action made or taken by an intermediate appellate board.
 - (6) If an agency grants an application for review or undertakes review on its own motion, it may affirm, modify, reverse, or set aside the order, decision, report or other action of the intermediate appellate board, or may remand the proceeding for reconsideration.
 - (7) The filing of an application for agency review shall be a condition precedent to judicial review of any order of an intermediate appellate board.

- (8) Agency employees performing review functions shall not be responsible to or subject to the supervision or direction of any employee or agent engaged in the performance of investigative or prosecuting functions for any agency.
- (b) Discretionary review of decisions of presiding officers
- (1) When a party to a proceeding seeks administrative review of an initial decision rendered by the presiding officer (or other officer authorized by law to make such decision), the agency may accord administrative finality to the initial decision by denying the petition for its review, or by summarily affirming the initial decision, unless the party seeking review makes a reasonable showing that:
- (A) a prejudicial procedural error was committed in the conduct of the proceeding, or
- (B) the initial decision embodies
- (i) a finding or conclusion of material fact which is erroneous or clearly erroneous, as the agency may by rule provide,
- (ii) a legal conclusion which is erroneous, or
- (iii) an exercise of discretion or decision of law or policy which is important and which the agency should review.
- (2) The agency's decision to accord or not to accord administrative finality to an initial decision shall not be subject to judicial review. If the initial decision becomes the decision of the agency, however, because it is summarily affirmed by the agency or because the petition for its review is denied, such decision of the agency will be subject to judicial review in accordance with established law.

Recommendation No. 7 - Elimination of Jurisdictional Amount
Requirement in Judicial Review

RECOMMENDATION

Title 28 of the United States Code should be amended to eliminate any requirement of a minimum jurisdictional amount before United States district courts may exercise original jurisdiction over any action in which the plaintiff alleges that he has been injured or threatened with injury by an officer or employee of the United States or any agency thereof, acting under color of Federal law. This amendment is not to affect other limitations on the availability or scope of judicial review of Federal administrative action.

Recommendation No. 8 - Judicial Review of Interstate Commerce
Commission Orders

RECOMMENDATION

Judicial review of orders of the Interstate Commerce Commission in cases where at present a special three-judge District court is used under 28 U.S.C. 2325 should be by petition to review in the United States Courts of Appeals in the same general manner as review of agency orders under the Judicial Review Act of 1950, 28 U.S.C. (Supp. II, 1967) 2341 - 2352.

Question II. You mention the need for additional statutory authority to enable the regulatory agencies to make a greater contribution to the process by which resources are allocated. Can you be a little more specific and state the kinds of new legislation you would like to see enacted?

Answer: An example of the type of additional statutory authority which I believe regulatory agencies should possess is the proposed Electric Power Coordination Act (H.R. 12585, introduced by Congressman Macdonald of Massachusetts). This bill would give the Federal Power Commission a larger role in the location of all electric generating facilities and high voltage transmission lines. Under existing law, the FPC has jurisdiction only over hydroelectric generating sites. In my view, the FPC could be much more effective in influencing the manner in which resources are to be devoted to an efficient electrical configuration in the United States, if its statutory authority were extended.

Question III. Throughout your statement you return to the theme of greater participation by various segments of the public in the decision-making process. Aside from the Ombudsman function you would like to see performed, do you have any other recommendations for encouraging and enabling more citizen participation?

Answer: In addition to the Consumers' Counsel and People's Counsel recommendations, I believe that greater citizen participation in the process by which our Nation's laws and our administrative rules and specific decisions are determined can be achieved through (a) imposing affirmative obligations on Government to publicize those areas in which laws, rules and decisions are to be considered; (b) requiring Governmental departments and agencies to seek the views of those who are affected by a proposed rulemaking (perhaps even supplying the expenses necessary to secure those views where that is essential); and (c) encouraging all communications forms, including both commercial and educational TV, radio and the press to do a more effective job in bringing public issues to the attention of the citizenry with greater creativity and imagination than has existed heretofore.

Chairman PROXMIRE. The committee will reconvene on Monday at 10 a.m. in this room to hear three outstanding experts on some fascinating case studies on waste and inefficiency, one on urban development policies, one on medicare-medicaid and one on institutional aid to higher education, from the Real Estate Research Corp., the Rand Corp., and Williams College.

The committee will be in adjournment until then.

(Whereupon, at 11:55 the committee recessed, to reconvene 10 a.m., Monday, September 22, 1969.)

